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GENERAL INTRODUCTION TO THE SURVEY

In accordance with decisions made by the “Fiscal Decentralisation Initiative for Central and Eastern Europe” (FDI), the OECD has initiated surveys on fiscal decentralisation for the purpose of providing international comparisons on the design of fiscal systems across levels of government.

FDI is a joint initiative of the OECD, the World Bank, the Council of Europe, the Open Society Institute, UNDP, USAID and OECD Member countries to assist transition economies in Central and Eastern Europe in carrying out intergovernmental reforms. The main objectives of the Initiative are: to encourage local democracies to improve the capacity of local governments to plan and administer expenditures and raise revenues; and to support local governments in their efforts to become more responsive and accountable to their constituencies.

Thereby the survey has been written in response to a questionnaire designed by the OECD and follows the structure outlined in the questionnaire.

The survey specifically indicates the state of the following fiscal decentralisation issues:

- The design of fiscal systems.
- The profile of sub-national revenues.
- The profile of sub-national expenditures.
- The match between locally-managed expenditures and the corresponding revenues.
- The institutional arrangements for ensuring fiscal discipline and budgetary constraints.
- The design of intergovernmental fiscal relations.

The surveys in 2000 took place in six countries in Central and Eastern Europe: three OECD Member countries - the Czech Republic, Hungary and Poland - and the three Baltic states - Estonia, Latvia and Lithuania.

The survey was carried out between April 2000 and January 2001.

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1. EXECUTIVE SUMMARY

1.1 Main features of local finance and intergovernmental relations

In Latvia there are three types of self-government:

- local governments of urban areas – big cities (republican cities);
- rural (*pagasts*) authorities and towns, and
- regional governments.

There are 578 municipalities in Latvia, including 7 urban municipalities representing big cities (republican cities), 26 regions (rajons), 73 towns and 472 rural municipalities (pagasts).

The resident population are 2 439 445, of which 1 683 556 urban population and 755 889 rural population. There are 1 224 463 population in republican cities, of which 796 732 lives in Riga the Capital of Latvia.

The big cities have the functions of both: the rural authorities, towns and the regions (at the same time). The rural authorities and towns (or the big cities) are not subordinated to the regions. The regions have separate functions and structures.

The general work principles of these municipal councils, their economy, competence, the rights and obligations of the council its institutions and chairmen, the relations of municipal councils with the Cabinet of Ministers and the Ministries, and the relations with other municipal councils are regulated by the Law “On Local Governments”.

The permanent functions of municipalities are specified in law “On Local Governments”. They shall be executed in accordance with the procedure established by respective laws and regulations of the Cabinet of Ministers.

The current Law “On local government”, article 15, stipulates 17 permanent tasks for rural authorities and towns and 4 permanent tasks for the regions (Rayons). The permanent tasks of the 7 “republican cities” are both those of the rural authorities and towns and those of the region – in total 21 permanent tasks.

Apart from the permanent tasks, the rural authorities and towns are also responsible for a number of temporary tasks (laid down by laws and regulations) and voluntary tasks. Among the most comprehensive temporary tasks are implementation of the land reform, restoration of property rights, and other questions related to privatisation of public properties. Voluntary tasks concern for instance local orchestras or tourism development initiatives.

The problem in Latvia, as in many other countries, is that the necessary standard of tasks is not detailed in law, and the minimum national standard service level is very seldom stipulated. To a wide extent, the division of these tasks (e.g. leisure activities for children) depends on the abilities of the regional and local

governments in the region and personal initiatives from politicians and administrative employees. Therefore, the current division of these “self government tasks” differs considerably from region to region.

Recent new legislation (Law on Administrative Territorial Reform) and reforms of existing legislation (Law On Local Governments) have been aimed at rationalising the number of local governments and improving the distribution of financing at the local and regional level to allow for better provision of services. There is wide consensus on the importance of building institutional capacity at the local level to improve functioning and service provision by the Local Governments and their municipal enterprises, however limited progress has been made in implementing the local government reform agenda.

1.2 -1.3 Major empirical findings. Main problems in the fiscal design

The revenue of Local Governments is generated from the following sources:

- percentages of state taxes:
 - 71.6% of the personal income tax;
 - 100% of the real estate tax;
- percentages of state duties;
- duties imposed by local governments;
- grants and earmarked grants allocated from the state budget;
- grants from the local government financial equalization fund;
- service fees.

Local governments are financed by shared taxes (income tax), inter-governmental transfers (state grants and earmarked grants) and state taxes (real estate tax) and own revenue (duties and fees). Shared taxes and transfers constitute by far the largest share of local government revenue (more than 70 percent in 1998-1999). Own local revenue is composed of fees and duties that the local governments can administer.

In accordance with binding regulations issued by the respective republican city or rural authority, town’ s municipal council, local governments may impose duties on the following:

- official documents issued by the urban or rural municipal council;
- organisation of entertainment in public places;
- accommodation of holiday-makers or tourists;
- commercial activities in public places;
- the keeping of animals, wild or domestic;
- driving through special protection zones;
- placing advertisements, posters or announcements in public places, containing visual commercial information;
- keeping boats, motor-boats or yachts;
- use of municipal symbols for commercial purposes.

Local governments have the right to collect state duties for issuing special permits (licences) to engage in specific types of businesses. These duties are paid to local government budgets.

Local governments receive grants and earmarked grants from the state budget for the fulfilment of specific tasks assigned to them under the Law “On Local Governments” and under other specific laws. The government of Latvia is working on the medium –term budget preparation program, but today there are no binding documents that would stipulate multi– annually the amount of specific and general grants for the Local governments. They are set annually at the national budget law.

Local governments still have limited autonomy to raise their own taxes. There are only state taxes in Latvia. Local Governments have a right to collect taxes and this is a real estate tax for all municipalities and in addition three municipalities: Riga, Ventspils, Liepaja collect also personal income tax. Municipalities don’t have a right to set the tax rate, to give tax exceptions etc. All taxes are set by the Central Government.

The most significant shortcoming in this important area of intergovernmental fiscal relations has been and continues to be the lack of tax autonomy. This minimum level of autonomy would create better accountability of local officials to constituents, increases the efficiency of public expenditure decisions, and is the best way to address the vertical imbalance between responsibilities and funding sources. Granting some degree of revenue autonomy to local governments has proven to be difficult, but needs to be addressed in the next round of intergovernmental finance reform.

Probable together with the implementation of administrative reform we will observe the possibility to give more rights for municipalities to set the real estate tax rate within some limits.

The choice of both the personal income tax and real estate tax as the major sources of revenues for local governments, is appropriate because their tax bases tend to be relatively stable during business cycles of the economy. They are not easily exportable, and there tends to be a linkage between the payment of these taxes and the benefits received by taxpayers from local public services.

Local governments have taken around 24 percent of general government revenues for the last three years.

The Equalization Mechanism. The current formula-driven Equalization Fund performs well in many respects. It has provided a good measure of objectivity in the determination of the equalization grants, it has provided the intergovernmental finance system with a high degree of equalization, and it has also contributed to increasing the revenue certainty and budgetary stability for local governments.

The Equalization Fund implements both revenue capacity equalization and expenditure needs equalization. This is quite proper for Latvia because there are not only significant disparities in revenue availability across local governments, but also different demands on local budgets arising from the demographic profiles and other cost factors.

The Rules on Local Governments’ borrowing. The government of Latvia observes strict financial and fiscal policy and the annual debt level for the municipalities is limited and is stated in the annual law on national budget. The ceiling for 1999 was 30 mill. Ls (the same as for 1998). The amount for the year 2000 being 17 mill. Ls where 10 mill. Ls of the total amount was for borrowing (and from that 0.5 mill. Ls was for the stabilisation of local governments finances) 7.0 mill. Ls are for guarantees. Along with the financial resources that are denominated in the national currency, and State Treasury can lend to the municipalities on favourable terms, with comparatively easy and fast procedures and without foreign exchange rate risk, the government has arranged credit facilities with the European Investment Bank and with the Nordic Investment Bank for the local government’s long term borrowing purposes. The Local Governments

borrowing procedures are strictly observed by the Local Governments Borrowings and Guarantees Board. Without permission from this Board Local Government has no right to borrow. If Local government wants to borrow from other Sources than the State Treasury, special permission from the Minister of Finance is requested.

Central Mandates on Economic Management. Municipal councils draft, adopt and implement their budget plans independently. State institutions are not allowed to interfere with the drafting and implementation of local budgets unless prescribed by law.

The Minister of Finance has prescribed a standard classification for the recording of local government budget revenue, expenditure and debt, and has established rules for budget accounts. Local government budget plans must always be balanced.

In accordance with State Treasury instructions, all the financial activities of the municipal councils are registered in the official local government financial accounts. The local government budget for the current budget year includes all the revenue collected or received by the local government (and its institutions) which is then used by the local government to achieve its goals.

Municipalities budget preparation and reporting system is getting better with every year.

Local governments' annual reports have to be audited by the state-sworn auditors from FY 2000 before submitting to the State Treasury.

The State Audit Office may check the budget accounts for the current budget year submitted by republican cities, regional, or rural authorities and towns' municipalities councils, concerning the implementation of their basic and the special budgets.

2. TECHNICAL FRAMEWORK – CLASSIFICATION OF LEVELS OF GOVERNMENT AND ECONOMIC TRANSACTIONS

2.1 Sub-national government finance statistics

In Latvia, there are three types of self-government:

- local governments of urban areas – big cities (republican cities);
- rural (*pagasts*) authorities and towns, and
- regional governments.

The big cities have the functions of both the rural authorities and towns, and the regions (at the same time). Neither the rural authorities and towns nor the big cities are subordinated to the regions. The regions have separate functions and structures - see below.

A local government is a local administrative body (council) of representatives elected by citizens which, with the help of institutions and organizations established by itself, fulfils the functions delegated to it by legislation and also the tasks delegated by the Cabinet of Ministers under the Law “On Local Governments”, as well as the fulfillment of the tasks initiated by the local government itself, ensuring that the interests of the state and the inhabitants of the relevant administrative area are served.

A regional government is the administrative body of a region (*rajons*, or county) which, with the help of the representatives elected by the local governments (the Council, and the institutions and bodies established by this Council), fulfils the functions delegated to it by legislation and also the tasks delegated to it by the local governments, ensuring that the interests of the state and the inhabitants of the relevant administrative area are served.

The council of the region is only indirectly elected as these councils consist of all the mayors from the local authorities within the borders of the region. The regions are nearly 100% financed by the grants from the local government finance equalization fund but they have their own independent budgets. The regions are, therefore, considered as local authorities in this analysis.

In Latvia, there are 578 municipalities, including 7 urban municipalities representing big cities (republican cities), 26 regions (*rajons*), 73 towns and 472 rural municipalities (*pagasts*).

The term Republican city is applied to those cities with advanced industrial, transportation and public service systems, and social infrastructure, or with developed institutions for culture and social care. The population in a republican city is at least 50 000.

The term town is applied to towns with advanced industrial and cultural centres, advanced social infrastructure and public services, and with a population of at least 2 000 people.

Republican cities perform all the mandatory functions of municipalities, whereas rural authorities and towns do not manage some functions (provision of public transport service, provision of civil protection activities, representation of the municipality in the regional sickness fund and co-ordination of further training of pedagogical staff and methodological activities of education).

Latvia's resident population totals 2 439 445, 1 683 556 of which live in urban areas and 755 889 which live in rural areas. Republican city-dwellers total 1 224 463, 796 732 of which live in Riga.

The population density (inhabitants per 1 km² of area) in Latvia is 37.8, but in Riga it is 2 595.2.

Riga is the capital of Latvia. 32% of Latvia's population lives in Riga, but 1.85% of the whole population lives in Ventspils. Riga City revenues accounted for 34.6% of all government revenues, in 1999. Ventspils City revenues accounted for 3.4% of all revenues. Riga City expenditures were 35.3% of all government expenditures, in 1999, whilst those of Ventspils City were 3.2%.

The Table below gives gross domestic product from 1997 to 1999.

Table 2.1 Gross Domestic Product, 1997-1999 (in Ls thousands)

Latvia	GDP at current prices
1997	3 275.5
1998	3 589.5
1999	3 662.3

Source: Monthly Bulletin of Latvian Statistics, 5(72)/2000, Riga, 2000 June, p.4.

GDP increased by 314,000Ls, or 9.58%, in 1998, and by 72,800Ls, or 2.03%, in 1999.

The table below groups Municipalities according to their number of inhabitants at the beginning of the year 2000.

Table 2.2 Grouping of Municipalities by size

Number of inhabitants*	Number of municipalities	Proportion of municipalities (%)	Proportion of the whole population in municipalities within the population range (%)
– 999	178	32.25	5.62
1 000 – 1 999	216	39.13	12.61
2 000 – 4 999	109	19.75	13.25
5 000 – 9 999	24	4.35	7.31
10 000 – 49 999	20	3.62	15.39
50 000 – 99 999	3	0.54	8.75
>100 000	2	0.36	37.07
Total	552	100.00	100.00

* According to the number of inhabitants at the beginning of the year 2000.

The general work principles of these municipal councils, their economy, competence, the rights and obligations of the council, its institutions and chairmen, the relations of municipal councils with the

Cabinet of Ministers and the Ministries, and the relations with other municipal councils are regulated by the Law “On Local Governments”.

Local and regional governments function independently within the limits of their competence and in compliance with the provisions laid down by legislation. A Ministry, as established by the Cabinet of Ministers under the Law “On Local Governments”, supervises their activities. At the moment, it is the Local Government Administration Unit, which carries out this supervision.

The State Audit Office supervises the way municipal councils manage their finances and property.

3. GOVERNMENT FINANCE STATISTICS ON SUB-NATIONAL GOVERNMENTS

General Comments

Data on sub-national government cover both the basic and special budgets of local government, including the privatisation fund and other special funds, for the financial years (FY) 1997, 1998 and 1999.

The submitted data are compiled by the Treasury based on annual reports reported by local governments. The reports of local governments are not audited. The data for the FY 1998 are compiled using the same methodology as for the FY 1997 and 1999. Therefore the data on the FY 1998 are specified and different from those submitted in Country Report: Latvia, The OECD 1999 Survey.

For the FY 1998 and 1999, the data on local governments include two levels of sub-national government (Regional governments, and Republican cities, Rural and Town municipalities). As far as the data on FY 1997 are concerned, the data regarding the “regional government” level includes both regional government and rural authorities and towns, because these levels were not separated, in 1997. At that time, only data on the second level, the Republican Cities, are shown.

3.1 Sub-national revenue

About Regional Governments

Regional revenue sources have seen some fundamental changes across the three reported years. While in 1997, taxes made up 41.2% of regional revenues, regional governments have not been assigned tax income since 1998. They now largely depend on grants which, in 1999, made up 73.1% of their revenues, and on non-tax income. This change of the regional revenue structure is partly due to the fact that the functions of regional governments were substantially reduced, in 1998. Most of the previous functions were transferred to the local governments. Furthermore, the decrease of regional revenues also has to be seen in the light of the fact that regional revenue data for 1997 included both data on the Regional Governments and the rural authorities and towns. These levels were only separated in 1998.

About Republican Cities, Rural Authorities and Towns

Major revenues of Local Government are tax revenues, non-tax revenues and grants (cf. Table 3.1).

With the delegation of previously regional government responsibilities to the local level, the local governments stand out now as the most important subnational government level in Latvia. In 1999, the localities had 92.3% of subnational revenues at their disposition, seen in relation to the revenue level of 1997, this is an increase of 80%. Although the local share of tax revenues – seen as a proportion of overall tax revenue – has increased since 1997, local governments are still not assigned a very large share: in 1999, the local tax share accounted for 17.1%. However, the composition of local revenues shows a decline in taxes by 5.4%. This was compensated by an increase in non-tax revenues and grants.

3.1.1 Tax revenue

The tables below classify subnational taxes and describe their tax composition.

In table 3.2, all local tax revenues are divided in accordance with the classification codes. As municipalities have no rights to determine the tax amount, all taxes are classified under category “e”. The tax revenues of Local Governments are composed of taxes on income, profits and capital gains, taxes on property and taxes on goods and services. The same pattern characterised regional governments in 1997: all the regional taxes belong to the “e”-category (cf. Table 3.3)

Local tax composition has remained relatively stable across the three reported years. In 1999, taxes on income, profits and capital gains constituted 77.4% of overall local tax revenues, property taxes made up 21%, while taxes on goods and services contributed only 1.6 % to the local coffers.

Table 3.1 Total revenue by level of government, 1997, 1998 and 1999, in millions of National Currency

	Central Government			Social Security Funds			Regional Government			Republican cities and Rural Authorities and Towns			General Government (Consolidated)		
	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999
Tax Revenue															
1000 Taxes on income, profits & capital gains	130.5	154.2	161				46			85.5	151.5	171.4	262	305.7	332.4
2000 Social security contributions				343.5	389.6	411.3							343.5	389.6	411.3
3000 Taxes on payroll and workforce	0	0	0										0	0	0
4000 Taxes on property	0	0.1	0.7				13.3			23.9	48.2	46.6	37.2	48.3	47.3
5000 Taxes on goods and services	440.7	493.7	483.8				5.7			0.9	3.4	3.5	447.3	497.1	487.3
6000 Other taxes	22.7	19.8	16.1										22.7	19.8	16.1
Total Tax Revenue	593.9	667.8	661.6	343.5	389.6	411.3	65	0	0	110.3	203.1	221.5	1112.7	1260.5	1294.4
Non-tax revenue															
Oper. surpl. of dept. enterpr. & prop. income	14	13.9	19.6							0.1	0.3	0.3	14.1	14.2	19.9
Fees, sales, fines	73.7	103.3	105.8				15.2	2.4	2.2	13.8	25.8	28.2	102.7	131.5	136.2
Contr. to govt. employee pension funds	0	0	0										0	0	0
Other Non-tax revenue	16.9	27.9	22.5				26	7.7	6	12.2	44.4	43.9	55.1	80	72.4
Total Non-Tax Revenue	104.6	145.1	147.9	0	0	0	41.2	10.1	8.2	26.1	70.5	72.4	171.9	225.7	228.5
Grants	0	0	0				51.7	21.1	22.3	30.6	71.3	71.2	0	0	0
Total Revenue	698.5	812.9	809.5	343.5	389.6	411.3	157.9	31.2	30.5	167	344.9	365.1	1284.6	1486.2	1522.9
Tax revenue as % of GDP	18.13%	18.60%	16.98%	10.49%	10.85%	10.55%	1.98%	0.00%	0.00%	3.37%	5.66%	5.68%	33.97%	35.12%	33.21%
Sub-national tax revenue as % of total tax revenue							5.84%	0.00%	0.00%	9.91%	16.11%	17.11%	100.00%	100.00%	100.00%

Table 3.2 Classification of taxes of sub-central governments. Local Government, 1997-99 (in millions of Ls)

1997									
Category	a	b	c	d.1	d.2	d.3	d.4	e	Total a-e
1000 Taxes on income, profits & capital gains								131.5	131.5
2000 Social security contributions									
3000 Taxes on payroll and workforce									
4000 Taxes on property								37.2	37.2
5000 Taxes on goods and services								6.6	6.6
6000 Other taxes									
Total	0	0	0	0	0	0	0	175.3	175.3
(% distribution)	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	100.00%	100.00%
1998									
Category	a	b	c	d.1	d.2	d.3	d.4	e	Total a-e
1000 Taxes on income, profits & capital gains								151.5	151.5
2000 Social security contributions									
3000 Taxes on payroll and workforce									
4000 Taxes on property								48.2	48.2
5000 Taxes on goods and services								3.4	3.4
6000 Other taxes									
Total	0	0	0	0	0	0	0	203.1	203.1
(% distribution)	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	100.00%	100.00%
1999									
Category	a	b	c	d.1	d.2	d.3	d.4	e	Total a-e
1000 Taxes on income, profits & capital gains								171.4	171.4
2000 Social security contributions									
3000 Taxes on payroll and workforce									
4000 Taxes on property								46.6	46.6
5000 Taxes on goods and services								3.5	3.5
6000 Other taxes									
Total	0	0	0	0	0	0	0	221.5	221.5
(% distribution)	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	100.00%	100.00%

Table 3.2.1 Classification of taxes of sub-central governments. Republican cities and Rural Authorities and Towns, 1997-99 (in millions of Ls)

1997									
Category	a	b	c	d.1	d.2	d.3	d.4	e	Total a-e
1000 Taxes on income, profits & capital gains								85.5	85.5
2000 Social security contributions									
3000 Taxes on payroll and workforce									
4000 Taxes on property								23.9	23.9
5000 Taxes on goods and services								0.9	0.9
6000 Other taxes									
Total	0	0	0	0	0	0	0	110.3	110.3
(% distribution)	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	100.00%	100.00%
1998									
Category	a	b	c	d.1	d.2	d.3	d.4	e	Total a-e
1000 Taxes on income, profits & capital gains								151.5	151.5
2000 Social security contributions									
3000 Taxes on payroll and workforce									
4000 Taxes on property								48.2	48.2
5000 Taxes on goods and services								3.4	3.4
6000 Other taxes									
Total	0	0	0	0	0	0	0	203.1	203.1
(% distribution)	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	100.00%	100.00%
1999									
Category	a	b	c	d.1	d.2	d.3	d.4	e	Total a-e
1000 Taxes on income, profits & capital gains								171.4	171.4
2000 Social security contributions									
3000 Taxes on payroll and workforce									
4000 Taxes on property								46.6	46.6
5000 Taxes on goods and services								3.5	3.5
6000 Other taxes									
Total	0	0	0	0	0	0	0	221.5	221.5

(% distribution)	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	100.00%	100.00%
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Table 3.3 Classification of taxes of sub-central governments. Regional Government, 1997-99 (in mill. of Ls)

1997									
Category	a	b	c	d.1	d.2	d.3	d.4	e	Total a-e
1000 Taxes on income, profits & capital gains								46	46
2000 Social security contributions									
3000 Taxes on payroll and workforce									
4000 Taxes on property								13.3	13.3
5000 Taxes on goods and services								5.7	5.7
6000 Other taxes									
Total	0	0	0	0	0	0	0	65	65
(% distribution)	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	100.00%	100.00%
1998									
Category	a	b	c	d.1	d.2	d.3	d.4	e	Total a-e
1000 Taxes on income, profits & capital gains									
2000 Social security contributions									
3000 Taxes on payroll and workforce									
4000 Taxes on property									
5000 Taxes on goods and services									
6000 Other taxes									
Total	0	0	0	0	0	0	0	0	0
(% distribution)	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
1999									
Category	a	b	c	d.1	d.2	d.3	d.4	e	Total a-e
1000 Taxes on income, profits & capital gains									
2000 Social security contributions									
3000 Taxes on payroll and workforce									
4000 Taxes on property									
5000 Taxes on goods and services									
6000 Other taxes									
Total	0	0	0	0	0	0	0	0	0
(% distribution)	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

3.1.3 Inter-government financial relations - grants

The profile of central grants to subnational governments is shown in Tables 3.4, 3.4.1 and 3.5. It is to be noted that specific grants do not include the specific grants for investment purposes.

Subnational governments mainly receive specific grants from the central government, they make up almost 90% of all the central transfers. From 1997 to 1999, the share of specific grants increased from 87.2% to 89.9% (cf. Table 3.4).

Table 3.4.1 breaks down data to the local level. However, strictly speaking, the figures are not comparable across the three years. In 1997, data includes republican cities only, while in 1998 and 1999 data includes republican cities, rural authorities and towns, excluding regions. But data shows very clearly that local governments mainly receive earmarked grants: in 1999, they made up 91.8% of all grants.

Table 3.4 The profile of central grants to sub-national governments, 1997, 1998 and 1999, in millions of Ls

Year	Specific Grants			General Purpose Grant			Total
	Current			Objective criteria		Discretionary	
	Conditional		Not Conditional	Without own tax effort	With own tax effort		
	Standard Costs	Actual Costs					
1997	71.8			10.5			82.3
1998	81.2			11.2			92.4
1999	84.1			9.4			93.5

Table 3.4.1 The profile of central grants to republican cities, rural authorities and towns, 1997, 1998 and 1999, in millions of Ls

Year	Specific Grants			General Purpose Grant			Total
	Current			Objective criteria		Discretionary	
	Conditional		Not Conditional	Without Own tax effort	With own tax effort		
	Standard Costs	Actual Costs					
1997	28.5			2.1			30.6
1998	64.0			7.3			71.3
1999	65.4			5.8			71.2

Table 3.5 The profile of central grants to regional governments, 1997, 1998 and 1999, in millions of Ls

Year	Specific Grants			General Purpose Grant			Total
	Current			Objective criteria		Discretionary	
	Conditional		Not Conditional	Without own tax effort	With own tax effort		
	Standard Costs	Actual Costs					
1997	43.3			8.4			51.7
1998	17.2			3.9			21.1
1999	18.7			3.6			22.3

In Table 3.5, data for 1997 is given on regional governments, including rural authorities and towns. The data for 1998 and 1999 only include figures for the regional governments. The specific grants for investment purposes are not included in the total amount of specific grants. Data shows the same pattern as for local governments. Grant transfers to regional governments include mainly specific grants. In 1999, they made up 83.9% of overall grants.

3.2 Sub-national expenditure

3.2.1 Sub-national expenditure by function and level of government

Table 3.6, below, shows current expenditure by functions and level of government from 1997 to 1999.

Table 3.6 Current expenditure by function and level of government, 1997, 1998 and 1999, in millions of Ls

		Central Government and Social Security			Regional Government			Republican cities, Rural Authorities and Towns			General Government (Consolidated)		
		1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999
1	General public services	73.9	74.1	62.4	20.5	4.8	4.9	13.4	34.7	40.6	107.8	113.6	107.9
2	Defence	21.8	16.8	25.2	0.2	0.1		0.2	0.3		22.2	17.2	25.2
3	Public order & safety	57.2	65.5	83.8	1.2	0.1		2.9	5	5.6	61.3	70.6	89.4
4	Education	53.6	60.7	63.5	80.7	18.5	18.9	59.3	144.2	154.2	193.6	223.4	236.6
04.010	Administration	1.2	1.3	1.2	0.5	0.3	0.5	0.5	0.8	1.2	2.2	2.4	2.9
04.100	Preliminary education affairs and services	0.1	1.1	0.1	12.1			14.4	29	32.2	26.6	30.1	32.3
04.200	Primary and Secondary education	23.5	25.9	26.4	60.7	15.3	15.4	37.8	98.2	105.1	122	139.4	146.9
04.300	Tertiary education	25.5	27.9	30.5							25.5	27.9	30.5
04.400	Education services not definable by level	1.8	1.8	2.0	5.3	2.4	2.5	5.2	11.2	11.7	12.3	15.4	16.2
04.500	Subsidiary services to education	0.1	0.1	0.1	1.3	0.1	0.1	0.9	2.1	2.4	2.3	2.3	2.6
04.600	Other education services	1.4	2.6	3.2	0.8	0.4	0.4	0.5	2.9	1.6	2.7	5.9	5.2
5	Health	114.9	131.7	143.3	4.3	0.2	0.2	2.2	4.3	3.6	121.4	136.2	147.1
6	Social Security & Welfare	428.2	505	587.4	14.5	5.4	5.7	11.6	23.3	24.7	454.3	533.7	617.8
7	Housing & community amenities	7.9	12.6	9	23.3	0.4	0.5	16.2	40.2	35.8	47.4	53.2	45.3
07.010	Administration of housing & community amenities	1.4	1.3	1.3							1.4	1.3	1.3
07.100	Housing & community amenities	0	0	0	18.4	0.1		3.3	19.6	18	21.7	19.7	18
07.200	Water supply affairs	0			0.3				0.5	0.3	0.3	0.5	0.3
07.300	Sanitary affairs	6.5	11.3	7.7	1.2	0.2	0.2	0.9	2.8	2.9	8.6	14.3	10.8
07.400	Street lightening affairs	0	0	0	0.3		0.1	1.4	2.6	2.4	1.7	2.6	2.5
07.500	Other housing & community affairs	0	0	0	3.1	0.1	0.2	10.6	14.7	12.2	13.7	14.8	12.4
8	Recreational, cultural & religious affairs	16.7	19.1	22.1	10.2	2.2	1.7	5.3	15.8	18	32.2	37.1	41.8
08.010	Administration of recreational, cultural & religious affairs	0.2	0.4	0.5				0.2	0.2	0.2	0.4	0.6	0.7
08.100	Sport and recreational affairs	1.6	2.6	2.9	1.0	0.4	0.4	0.5	1.2	1.6	3.1	4.2	4.9
08.200	Culture	8.5	9.1	11.6	9.2	1.8	1.3	4.6	14.3	15.9	22.3	25.2	28.8
08.300	Broadcasting and publishing affairs	5.6	6.4	6.6							5.6	6.4	6.6
08.400	Religion affairs	0.1	0	0							0.1	0	0

		Central Government and Social Security			Regional Government			Republican cities, Rural Authorities and Towns			General Government (Consolidated)		
		1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999
08.500	Movies affairs	0.7	0.6	0.5							0.7	0.6	0.5
08.600	Other affairs	0	0	0					0.1	0.3	0	0.1	0.3
9	Fuel & energy	0.3	0.2	0.2	0.4			0.1	2.1	0.2	0.8	2.3	0.4
10	Agriculture, forestry, fishing & hunting	42.9	71.7	67.9	0.3				0.3	0.4	43.2	72	68.3
11	Mining, manufacturing & construction, except fuel & energy	0.5	0.6	0.7							0.5	0.6	0.7
12	Transportation & communication	49.6	54.2	53.3	8.1	2.7	3.1	6.9	13.8	12.8	64.6	70.7	69.2
13	Other economic affairs	6.5	12	18.3	5.6			2.8	0.8	0.8	14.9	12.8	19.1
14	Other functions	27.3	39.7	28	1.5	3.1	4.4	0.8	10.9	13.5	29.6	53.7	45.9
15	Total current expenditure	901.3	1 063.9	1 165.1	170.8	37.5	39.4	121.7	295.7	310.2	1 193.8	1 397.1	1 514.7
16	Total current government expenditure.												
	% of GDP	27.52%	29.64%	29.90%	5.21%	1.04%	1.01%	3.72%	8.24%	7.96%	36.45%	38.92%	38.87%

Data in Table 3.6 are shown in accordance with the International Monetary Fund Classification. Data on Central Government and the Social Fund are consolidated and only given on current expenditures. Transfers to other levels of government are excluded from Central Government and Social Fund current payments. Municipal budgets are also consolidated. Inter-municipal payments and municipal payments to the equalisation fund are subtracted. Data on Central Government and municipal budgets are internally consolidated.

About Regional Governments

The data for 1997 for the “Regional government” level includes both data on Regional Governments and the rural authorities and towns. These levels were not separated in 1997.

Seen as a percentage of overall general government expenditure, the total expenditures of regional governments, rural authorities and towns accounted for 14.30% in 1997. In 1998 and 1999, the share of regional expenditure made up 2.7% and 2.6%. Expenditures of regional governments are primarily directed to general public services, education (especially primary and secondary education), housing and community amenities, and social security and welfare. The main expenditure item is education, which constitutes 48.0% of regional expenditures in 1999.

About Republican Cities, Rural Authorities and Towns

Much like the regions, the expenditures of republican cities, rural authorities and towns are also primarily directed to general public services, education (especially primary and secondary education), housing and community amenities, and social security and welfare. Seen as a proportion of overall general government (consolidated) expenditures, the expenditures of the “local” level (republican cities, rural authorities and towns) accounted for 21.17% in 1998 and 20.48% in 1999. Expenditures on education made up the largest share: 48.77% in 1998 and 49.71% in 1999, the bulk of it directed to primary and secondary education (68% of all the local education expenditures). In 1998 and 1999, housing made up 13.6% and 11.54% of local expenditure, respectively. At the same time, social security items received approximately 8% of local funds.

3.2.2 Expenditure indicators by the three most important policy sectors

In Table 3.7. data are chosen for the three largest expenditure categories, classified in functional classification under codes 4.2.; 8.2.; 4.4. In the first line “Local governments expenditure in mill. lats” data is given for all municipal expenditures on policy sectors. In the second line percentage is calculated as “total sector expenditures of municipalities as a portion of total municipal expenditures”. Total municipal expenditures are given in the table 3.6. (Summing up total current expenditures for Regional governments and Republican cities, Rural Authorities and Towns). In the third and fourth line total municipal sector expenditure is calculated as a portion of General Government (Consolidated) sector expenditure.

Local expenses on primary and secondary education remained stable over the three reported years, they made up 34 % of overall local expenditures. As a proportion of total government expenditure in this policy sector, this expenditure item accounted for 82% in 1999.

Local Government expenditures for cultural activities have increased only very slightly over the reported years, from 4.7% of overall local expenditures in 1997 to 4.9% in 1999. At the same time, local expenditures made up 59,7% of total government expenditure on (policy sector).

Local Governments expenditures to education services not definable by level were 10.5 million Ls in the year 1997. They have increased by 3.1 million Ls or 29.52% in the year 1998 and by 0.6 million Ls or 4.41% in the year 1999. From total Local government expenditures, Local Government expenditures to education services not defined by level were 3.6% in the year 1997, 4.1% in the year 1998 and 4.1% in the year 1999. From total government expenditure on (policy sector) Local Government expenditures were 85.4% in the year 1997, 88.3% in the year 1998 and 87.7% in the year 1999. From total government expenditure on (policy sector) local and regional expenditures were 85.4% in the year 1997, 88.3% in the year 1998 and 87.7% in the year 1999.

Table 3.7 Expenditure indicators by the three most important policy sectors. Local government. 1997, 1998 and 1999, in millions of Ls, and as a percentage

	4.2.			8.2.			4.4.		
	Primary and Secondary education			Culture			Education services not definable by level		
	1997	1998	1999	1997	1998	1999	1997	1998	1999
Local government expenditure (on policy sector), in millions of National Currency	98.5	113.5	120.5	13.8	16.1	17.2	10.5	13.6	14.2
	%	%	%	%	%	%	%	%	%
Local government expenditure (on policy sector) as a proportion of total local government expenditure	33.7	34.1	34.5	4.7	4.8	4.9	3.6	4.1	4.1
Local government expenditure as a proportion of total government expenditure on (policy sector)	80.7	81.4	82.0	61.9	63.9	59.7	85.4	88.3	87.7
Local and regional expenditure (all subnational expenditure on the policy sector in question) as a proportion of total government expenditure on (policy sector)	80.7	81.4	82.0	61.9	63.9	59.7	85.4	88.3	87.7
Local government expenditure (on policy sector) covered by specific grants									
Local government expenditure (on policy sector) covered by non-tax revenues									

Table 3.7.1 Expenditure indicators by the three most important policy sectors. Republican Cities, Rural Authorities and Towns. 1997, 1998 and 1999, in millions of Ls, and as a percentage

	4.2			8.2			4.4		
	Primary and Secondary education			Culture			Education services not definable by level		
	1997	1998	1999	1997	1998	1999	1997	1998	1999
Local government expenditure (on policy sector), in millions of National Currency	37.8	98.2	105.1	4.6	14.3	15.9	5.2	11.2	11.7
	%	%	%	%	%	%	%	%	%
Local government expenditure (on policy sector) as a proportion of total republican cities, rural authorities and towns expenditure	31.1	33.2	33.9	3.8	4.8	5.1	4.3	3.8	3.8
Local government expenditure as a proportion of total government expenditure on (policy sector)	31.0	70.4	71.5	20.6	56.7	55.2	42.3	72.7	72.2
Local and regional expenditure (all subnational expenditure on the policy sector in question) as a proportion of total government expenditure on (policy sector)	80.7	81.4	82.0	61.9	63.9	59.7	85.4	88.3	87.7
Local government expenditure (on policy sector) covered by specific grants									
Local government expenditure (on policy sector) covered by non-tax revenues									

In Table 3.7.1, data are chosen for three expenditure categories, classified in functional classification under codes 4.2.; 8.2.; 4.4. In the second line percentage is calculated as “total sector expenditure for *Republican cities and rural authorities and towns* as a portion of total expenditures for *Republican cities and rural authorities and towns*”. In the third line total sector expenditure for *Republican cities and rural authorities and towns* is calculated as a portion of General Government (Consolidated) sector expenditure. In the fourth line total sector expenditure for *municipalities (regional and local)* is calculated as a portion of General Government (Consolidated) sector expenditure

Republican cities’ expenditures to primary and secondary education were 37.8 million Ls in the year 1997. Republican cities and rural authorities and towns expenditures to primary and secondary education were 98.2 million Ls in the year 1998. They have increased by 6.9 million Ls or 7.03% in the year 1999. From the total Republican cities’ expenditures, expenditures to primary and secondary education were 31.1% in the year 1997, Republican cities, rural authorities and towns expenditures were 33.2% in the year 1998 and 33.9% in the year 1999. From total government expenditure on (policy sector) Republican cities expenditures to primary and secondary education were 31.0% in the year 1997, Republican cities, rural authorities and towns expenditures were 70.4% in the year 1998 and 71.5% in the year 1999. From the total government expenditure on (policy sector) local and regional expenditures to primary and secondary education were 80.7% in the year 1997, 81.4% in the year 1998 and 82% in the year 1999.

Republican cities’ expenditures to culture were 4.6 million Ls in the year 1997. Republican cities, rural authorities and towns expenditures to culture were 14.3 million Ls in the year 1998. They have increased by 1.6 million Ls or 11.19% in the year 1999. From the total Republican cities’ expenditure, Republican cities expenditures to culture were 3.8% in the year 1997, Republican cities, rural authorities and towns expenditures were 4.8% in the year 1998 and 5.1% in the year 1999. From total government expenditure on (policy sector) Republican cities expenditures to culture were 20.6% in the year 1997, republican cities’ rural authorities and towns expenditures were 56.7% in the year 1998 and 55.2% in the year 1999. From total government expenditure on (policy sector) local and regional expenditures to culture were 61.9% in the year 1997, 63.9% in the year 1998 and 59.7% in the year 1999.

Republican cities’ expenditures to education services not definable by level were 5.2 million Ls in the year 1997. Republican cities, rural authorities and towns expenditures to education services not definable by level were 11.2 million Ls in the year 1998. They have increased by 0.5 million Ls or 4.46% in the year 1999. From total Republican cities’ expenditure, Republican cities expenditures to education services not definable by level were 4.3% in the year 1997, republican cities, rural authorities and towns expenditures were 3.8% in the year 1998 and in the year 1999. From total government expenditure on (policy sector) Republican cities’ expenditures to education services not definable by level were 42.3% in the year 1997, republican cities, rural authorities and towns expenditures were 72.7% in the year 1998 and 72.2% in the year 1999. From total government expenditure on (policy sector) local and regional expenditures to education services not definable by level were 85.4% in the year 1997, 88.3% in the year 1998 and 87.7% in the year 1999.

Table 3.8 Expenditure indicators by the three most important policy sectors. Regional Government. 1997, 1998 and 1999, in millions of Ls, and as a percentage

	4.2			8.2			4.4		
	Primary and Secondary education			Culture			Education services not definable by level		
	1997	1998	1999	1997	1998	1999	1997	1998	1999
Local government expenditure (on policy sector), in millions of National Currency	60.7	15.3	15.4	9.2	1.8	1.3	5.3	2.4	2.5
	%	%	%	%	%	%	%	%	%
Local government expenditure (on policy sector) as a proportion of total regional expenditure	35.5	40.8	39.1	5.4	4.8	3.3	3.1	6.4	6.3
Local government expenditure as a proportion of total government expenditure on (policy sector)	49.8	11.0	10.5	41.3	7.1	4.5	43.1	15.6	15.4
Local and regional expenditure (all subnational expenditure on the policy sector in question) as a proportion of total government expenditure on (policy sector)	80.7	81.4	82.0	61.9	63.9	59.7	85.4	88.3	87.7
Local government expenditure (on policy sector) covered by specific grants									
Local government expenditure (on policy sector) covered by non-tax revenues									

In Table 3.8, data are chosen for three expenditure categories, classified in functional classification under codes 4.2.; 8.2.; 4.4. for regional governments. In the second line percentage is calculated as “total sector expenditure *for regional governments* as a portion of total expenditures *for regional governments*”. In the third line total sector expenditures *for regional governments* is calculated as a portion of General Government (Consolidated) sector expenditure. In the fourth line total sector expenditure for *municipalities (regional and local)* is calculated as a portion of General Government (Consolidated) sector expenditure. The data for the year 1997 for the “Regional government” level includes both the data on the Regional Governments and the rural authorities and towns. These levels were not separated in the year 1997.

Regional education expenditures did not change much from 1998 to 1999. Seen as a share of total regional expenditures, they made up 40.8% and 39.1%, respectively. In the same period, regional expenditures as a proportion of total government expenditure on the policy sector accounted for 11.0% and 10.5%. As a share of total regional government expenditure, rural authorities and town expenditures on education services not definable by level were 3.1% in 1997, 6.4% in 1998, and 6.3 % in 1999.

4. EVALUATIONS ON SUB-NATIONAL AUTONOMY AND NATIONAL FISCAL CONSTRAINTS

4.1 General presentation of the sub-national government system. Summary on government finance reform policies

The permanent functions of municipalities are specified in the law “On Local Governments”. They are executed in accordance with the procedure established by laws and regulations of the Cabinet of Ministers. In Table 4.1 below, X indicates when a level has major functions within the sector area. Cf. also Table 3.6, “Current expenditure by function and level of government, 1997, 1998 and 1999, in millions of Ls”, for a more detailed division of tasks and responsibilities.

Municipalities shall organise and be responsible for the execution of the permanent functions. Execution of these functions shall be financed from the budget of the respective municipal budget, if not stipulated otherwise under this law.

When new permanent functions involving increased expenditure are transferred to municipalities, the law by which the execution of these functions is delegated, shall simultaneously determine new sources of income for that municipality.

Table 4.1 Expenditure Assignment – Actual Status of the legal framework

		Central Government	Regional Government (1)	Local Government	
				Big cities	Rural pagasts
1	General public services	X	X	X	X
2	Defence	X	X (civil defence)	X (civil defence)	
3	Public order & safety	X		X(public order)	X (public order)
4	Education	X	X	X	X
5	Health	X	X	X	X
6	Social Security & Welfare	X		X	X
7	Housing & community amenities			X	X
8	Recreational, cultural & religious affairs	X		X	X
9	Economic services	X		X	X
10	Fuel & energy	X		X	X
11	Agriculture, forestry, fishing & hunting	X		X	X
12	Mining, manufacturing & construction, except fuel & energy	X		X	
13	Transportation & communication	X	X	X	X
14	Other economic affairs	X	X	X	X
15	Other functions			X	X
16	Civil defence		X	X	

Apart from the permanent tasks, the rural authorities and towns are also responsible for a number of temporary tasks (laid down by laws and regulations) and voluntary tasks. Among the most comprehensive temporary tasks are the implementation of the land reform, the restoration of property rights, and other matters related to the privatisation of public property. Voluntary tasks concern, for example, local orchestras, tourism development initiatives, etc. A summary of local government functions is given in Table 4.1.1 below.

Table 4.1.1 Categorisation of local government functions

Category (type) of function	Legal basis of performing the function	Responsibility for performing the function	Source of financing
1. Compulsory functions			
1.1. Permanent	Law “On Local Governments”	Local government	Local government budget
1.2. Temporarily delegated functions	Other laws	Local government	Supplementary financing must be assigned by law
1.3. Function delegated by state administration	Laws or regulations issued by the Cabinet	State administration institutions	Budget of the state administration institution
1.4. One-off tasks	Decision (order) of the Cabinet	Local government	The Cabinet or local government budget
2. Functions of other local governments	Agreement between local governments	The local government which has delegated the function to some other local government	The source of financing to be indicated in the agreement
3. Voluntary functions (initiatives)	Decision taken by the relevant municipal council	Local government	Local government budget

The law “On Local Governments” determines the temporary and voluntary functions of local governments.

By passing a new law, municipalities can be assigned temporary functions that are not stipulated in the law “On Local Governments”. The new law simultaneously provides additional sources of financing if the execution of such functions involves increased expenditure.

State administration institutions may authorise municipalities to execute certain of their functions if this is stipulated in the laws or regulations of the Cabinet of Ministers. The execution of these functions must follow an established procedure, and be supervised. The municipality will be simultaneously provided with the funding provided for in the budget of the respective state administration institution for the execution of said function. The municipality organises the execution of the transferred function, but the delegating state administration institution remains responsible for its execution.

Municipalities may transfer the execution of certain functions under their competence to each other, on mutual agreement, and by decision of the municipality councils concerned. The transfer is the subject of a written contract which also stipulates the sources of financing for said functions.

Special inter municipal co-operation exists for the execution of some functions, mainly in the spheres of education and social security. The law “On Education” gives the family the right to choose the educational

establishments for their children, irrespective of domicile. The financing for the person's education or social service is transferred to the municipality according to the person's residence. If someone chooses another municipality's services, there will be inter-municipal co-operation and payments.

Municipalities also co-operate in the spheres of waste disposal and the establishment of waste dumps, transportation, tourism, etc.

Table 4.1.2 Revenue from inter –municipal payments (Ls)

Year	Revenue from inter–municipal payments	Revenue in Total	Inter–municipal payments as (%) of total revenue
1997	3 579 925	331 231 635	1.08%
1998	5 924 725	380 350 768	1.56%
1999	6 399 164	397 524 726	1.60%

The Cabinet of Ministers may assign the execution of certain single tasks to municipalities, and will simultaneously provide the funds necessary. If municipalities agree, they may execute single tasks at their own expense.

Municipalities can voluntarily implement their initiatives with respect to any issue, in the interests of the residents of their administrative territory, if it is not within the competence of the Constitution, the Cabinet of Ministers, ministries, other public administration institutions, the courts or other municipalities, and providing such activities are not prohibited by law.

The public administration institutions cannot delegate to municipalities the execution of functions for which financing is not provided.

The current Law “On local government”, article 15, stipulates 17 permanent tasks for rural authorities and towns, and 4 permanent tasks for the regions (Rayons), making 21 permanent tasks in total. The permanent tasks of the 7 “republican cities” are those of both the rural authorities and towns, and those of the region. (See Section 4.6, “Local discretion – expenditure”, below.)

The problem in Latvia is that the law does not detail the standards to be reached when carrying out a task, and rarely stipulates a minimum national standard.

To a large extent, the division of these tasks (e.g. leisure activities for children) depends on the abilities of the regional and local governments, and the personal initiatives of politicians and administrative employees. Therefore, the current division of these “self-government tasks” differs considerably from region to region.

A working group has been set up, by the Cabinet of Ministers, to work out proposals for a clear division of functions between levels of government, and, specifically, the division of functions such as education and social welfare.

Recent new legislation (Law on Administrative Territorial Reform) and reforms of existing legislation (Law On Local Governments) have aimed at rationalising the number of local governments, and improving the distribution of financing at the local and regional level, to allow for a better provision of services. There is wide consensus on the importance of building institutional capacity at the local level to improve functioning and service provision by the Local Governments and their municipal enterprises, however, limited progress has been made in implementing the local government reform agenda.

A summary of recent reforms of central-local relations

After gaining the independence, decentralisation and democratisation of central power and administration can be witnessed in Latvia. This is closely connected with the development of municipal system. One of the elements characterising municipal and public administration structure is a marked administrative territory, within the limits of which a municipality and public administration institutions perform their activities.

The existing administrative territorial division of Latvia is a heritage from the Soviet period. Already with the beginning of the 90's attempts have been made to reform the administrative division, to reorganise it according to the present-day needs, yet no results have been achieved. Although the law "On the Administrative-territorial Reform", which determines the reform process, was passed, still there are big problems to establish a consistent development of the process, as well as to provide the necessary financial resources.

The existing division of Latvia in regions and rural districts does not demonstrate an administrative territorial structure formed historically and representing certain historic principles or criteria, but the reorganisation of the economic management, taking place in the 60's. During the Soviet times regional territories basically performed the role of economic management unit. The administrative regions were used as the territorial units of economic planning, management and control. Rural district territories were adjusted with the territories of the collective farms.

Up to the present moment the local government reform was directed at revisions not involving fundamental basic changes. The rural district and town municipality functions have been added, as well as their independence and responsibility increased, while the municipal administrative territorial division with minor changes has stayed the same from the previous regime. It was formed in the 60's and 70's for the centralised administration. It is dominated by territories with small number of inhabitants and, consequently with a weak financial revenue base.

Such municipalities cannot efficiently execute their functions. Lack of uniformity of the financial resources among the big number of small municipalities and big volume of the interrelated payments provides no possibility for rational usage of the already lacking municipal financial resources, planning and management of the financial resources often is quite weak.

To execute the municipal functions and provide qualitative services to inhabitants, it is necessary to form qualified, specialised municipal administration, to separate municipal decision-making power from the executive institutions. However, it is not possible for the municipalities with small number of inhabitants due to the relatively big already existing administrative expenses, which results in decreasing of the municipal management effectively and quality of the services provided.

As the administrative territory investigation data show, most of inhabitants are not sufficiently informed on the process of the administrative-territorial reform and the necessity for it. Most of the municipality deputies and officials perceive the reform as a pressure from the central government. Most of the inhabitants and municipal politicians and employees are against the amalgamation of municipal territories. They represent an opinion that presently there is no need to change the existing administrative-territorial division.

The investigation data on the administrative territories show that in most cases rural district municipalities prefer organising inter-municipal co-operation, while preserving the existing administrative division, to the amalgamation of the administrative territories. However, it has to be doubted whether municipal co-operation will be effective enough, as in most cases the co-operation associations tend to have a hierarchical multi-level structure, not understood by the inhabitants, the process of decision-making is slow and heavy, the financial situation is not stable as the budgets are comparatively small; possibilities to obtain credits are unclear and limited. The danger of application of veto rights by the included municipalities or threats to secede from the association are present.

Encountering the unstable character of the municipal co-operation, the situations might occur that municipal co-operation associations are formed, which after the implementation of the reform become formal or collapse. Thus the state budget resources would be spent for the reform and much of efforts applied, but the administrative territorial division would stay the same with just few exceptions.

The preparatory process of the administrative-territorial reform up to present was developing in unstable political conditions and without the provision of required financial resources both for the implementation of the reform activities and for the state investments for the infrastructure development – the aspects, which have left essential impact on the reform development.

Although the administrative-territorial reform cannot be viewed as a magic treatment for improving the municipality situation it will create a better basis for the possibilities to solve many of the urgent problems. When comparing the essential municipal problems and possibilities, one can see that the reform is able to solve the problems, which are connected with the small municipal capacity, discrepancy between the number of municipal employees and the amount of the functions. With other beneficial conditions it might be possible for the territorial reform to solve the issues of budget spending effectively, attracting of investments and intellectual potential, increasing the possibilities of international municipal co-operation. Municipal amalgamation just provides the possibility of the development of the municipality, while all the results depend only on the work done by the respective municipality.

To overcome the consequences of totalitarianism, to reform the system of the administrative territories formed for the centralised administration and to continue decentralisation of public administration, strengthening of the municipal system, the territorial reform has to be implemented by closely observing the order of the activities and terms of implementation as determined by the law “On the Administrative-territorial Reform” and by ensuring the quality of the activities determined by the law.

To ensure timely and qualitative execution of the activities determined by the law, the implementation of the territorial reform has to be provided with the necessary financial resources. Municipal amalgamation has to be linked with the state investments for ordering and development of the infrastructure. More attention has to be paid to the formation of public relationships for the reform, informing inhabitants, municipal politicians and employees on the aims, objectives and process of implementation of the reform.

Law on local government

The Law on Local Government from 1994 (with later amendments) laid down the legal framework for the local government, including the competencies, functions, structure and general finance. The approval of this act was a key milestone in the reform of the system of local governments in Latvia, and the main principles of this law has been kept unchanged since that time.

Equalisation

The year 1994 was a period of gradual transition from extremely centralised procedure of local government financing to a decentralised model of local government financing in compliance with the recommendations by the Council of Europe. The equalisation grant of lats 13.4 million, in 1994, was to be allocated to all local government budgets except to those of three cities— Riga, Liepaja and Ventspils.

The first equalisation law was passed in 1995 and was named “On Equalisation of Local Government Finances in 1995”. Each following year a new law was passed, i.e. “On Equalisation of Local Government Finances in 1996”, “On Equalisation of Local Government Finances in 1997” until the development in 1998 of the Law “On Equalisation of Local Government Finances” which is in force even today. The existing equalisation system in Latvia is based on the above law, the principle of which is the balancing of

needs and expenditure on the basis of objective criteria. In the course of time since 1995 the system of local government financial equalisation has been improved but the basic principles have remained.

Table 4.5 Revenue in the Local Government Financial Equalisation Fund in 1995-1998

LGFEF* revenue, million Ls		
Year	Total	including state budget grant
1995	75.1	62.7
1996	57.9	20.7
1997	84.2	52.8
1998	27.1	2.7
1999	30.1	6.1

Note: * LGFEF - Local Government Financial Equalisation Fund

The Law “On Equalisation of Local Government Finances”, March 5, 1998, is the first general law, which determines the main equalisation principles, and these principles need not to be debated every year over again; this increases the stability of the local government financing system. The local government financial equalisation system is stable because the basic revenue source, the income tax, in the local government budgets is guaranteed by the central government/ state budget.

4.2 Local discretion – Tax administration and relation to central government

Latvia has the following system of taxes and duties:

- state taxes imposed by parliamentary laws which are promulgated by the President of the State;
- state duties imposed by parliamentary laws which are promulgated by the President of the State;
- state duties imposed by the Cabinet of Ministers;
- local government duties imposed by municipal councils under the Law “On Taxes and Duties” and in compliance with Regulations by the Cabinet of Ministers “On the Procedure for Imposing Local Government Duties”.

There are no municipal taxes in the Republic of Latvia, though Local Governments have the right to collect what represents real estate tax for all municipalities. In addition, three municipalities, Riga, Ventspils and Liepaja, also collect personal income tax. Municipalities cannot set the tax rate, or give tax exemptions, etc. All taxes are set by the Central Government and therefore Latvia only has state taxes, with some of them being allocated to Local Government budgets.

Under the existing system of taxation, tax rates are usually set according to the proportionality principle, and, more seldomly, according to the progressive taxation principle.

The state (the Government) imposes the following taxes:

- personal income tax;
- company profit tax;
- value added tax;
- excise tax;
- excise on oil products;
- excise on tobacco products;
- excise on alcoholic beverages;
- customs tax;¹
- natural resources tax;
- tax on lotteries and games of chance;
- compulsory social insurance contributions².

The tax rates are set on a multi–annual basis.

The budgetary rights of local governments, their autonomy, and relations with the state budget and the budgets of other local governments, are governed by the following laws: “On Local Government Budgets”, “On Budgetary and Financial Management”, “On Local Governments”, the tax laws, and other legislative acts.

The revenue of local governments is generated from the following sources:

- percentages of state taxes:
 - 71.6% of the personal income tax;
 - 100% of the real estate tax;
- percentages of state duties;
- duties imposed by local governments;
- grants and earmarked grants allocated from the state budget;
- grants from the local government financial equalisation fund;
- service fees.

¹it should be called “customs duty” (*trans.*)

²called “social tax” in conversational Latvian (*trans.*)

Personal income tax

The tax base and the tax rate of personal income tax are set by the central government without influence from the local governments. The local authorities are guaranteed the central government prognoses of the tax base. The law “On local government finance equalisation” states that a procedure must be established, at the Regulation of the Cabinet of Ministers, on how the state budget income will guarantee the prognoses of income tax should the real tax execution be less than that forecast.

If the collected amount of tax is smaller than that forecast, the difference will be covered with the state budget revenues. This is partly done to ensure that Local Governments make their payments to the Equalisation fund, because Local Government contributions are calculated as a percentage of forecast personal income tax. This is also partly taken over because the forecast is set and the tax administration is carried out by the Central Government.

Personal income tax is imposed under the Law “On Personal Income Tax”. The tax rate is 25% of the annual taxable income of an inhabitant. The amount paid by an inland tax payer (resident) is transferred to the state budget and distributed as follows:

- 28.4% to the special health care budget of the state, and
- 71.6% to the local government budget according to the place of residence of the inhabitant, and to the local government financial equalisation fund.

The amount of tax money paid by non-residents is transferred to the local government budget according to the municipality where the employer or the person’s real property is located.

This tax is transferred to the personal income tax distribution account of the State Treasury.

Personal income tax revenue is allocated to local government budgets in a centralised way through the State Treasury, but personal income taxes paid by the inhabitants of Riga, Ventspils and Liepaja cities, if the inhabitants are employed in the same administrative territory, are directly transferred to the local government budget accounts of said cities. Riga, Ventspils and Liepaja are republican cities that perform both regional and local functions.

Real property tax

The central government sets the tax base and the tax rate. The central government prognoses of the local government’s tax base has only been guaranteed since 1998.

Real property is taxed under the Law “On Real Property Tax”. Property tax shall be levied on things with real existence (physical) situated within the territory of the Republic of Latvia, and which cannot be moved from one place to another without causing external damage to land, buildings or constructions (hereinafter referred to as real estate), with the exception of the real estate mentioned in paragraph 2 of article 1”.

Exemptions from the tax base are set in the law on “On Real Property Tax” (article 1, paragraph 2) and are as follows:

(2) Real estate tax shall not be levied on:

1. municipal real estate that is used by the municipal council (dome) and the institutions formed by it, or which is financed from the municipal budget and located within the administrative territory of the respective municipality, as well as such municipal immovable property that has been

passed to the medical or social care institutions registered in the status of a municipal enterprise. The real estate of other municipal enterprises shall be taxed;

2. the real estate in the possession of a foreign state used for the needs of the diplomatic and consular representation of such state, under the condition that the Republic of Latvia, in compliance with the legislation of the respective foreign state, enjoys the same right with regard to the real estate in possession of Latvia in the respective foreign country;
3. highways, air and water navigation buildings and public water bodies for communal use;
4. the real estate of religious organisations;
5. the land on which economic activities are prohibited by law;
6. such real estate that has been acknowledged as a cultural monument of the Republic of Latvia and the land required for its maintenance, except residential houses and the land for their maintenance as well as the real estate to be used in economic activities;
7. pursuant to the procedure established by the Cabinet of Ministers, the land of undergrowth and reforested areas of the age of undergrowth;
8. centres of active, mass recreation, sports facilities and the land required for their maintenance, irrespective of ownership, in compliance with the regulations of the Cabinet of Ministers;
9. until 31st December, 2003: property consisting of individual (family) residential houses and apartments, if such property is not used for commercial purposes.

The tax rate is 1.5% of the cadastral value of the real property, this value being determined by the State Land Service. It is stated in law that, from 2002, the tax rate will be changed from 1.5% to 1% of the cadastral value of the whole real property.

Local governments may issue binding regulations to grant tax benefits for some categories of real property owners; such benefits are expressed as percentages of the real property tax — 90%, 75%, 50% or 25%.

The real property tax is the only tax which is received directly by the local government on whose territory the real property, or part of it, is located.

For the forecasting of real property tax, the taxable tax base is multiplied by the tax rate, and a coefficient of levy - ability is calculated, that is 0.95.

The above analysis shows that the local government has very limited possibilities for adjusting the revenues to meet expenditure needs (service level). The central government sets the major revenue sources i.e. taxes and state grants, and there are only a few revenue sources of minor importance whose level local authorities have any possibility of deciding.

Recent major tax reforms directed to sub-national governments

In 1991, when Latvia regained its sovereignty, a new system of taxes was developed which was based on the Law “On Taxes and Duties in the Republic of Latvia”. The most important aims of this tax law are:

- to ensure that in the state budget there are the financial resources required for the implementation of social and economic measures:

- to develop the stability of local government budgets;
- to ensure favourable economic conditions for commercially and financially independent business activities;
- to create better conditions for expansion and increased efficiency of business activities;
- to apply effective economic sanctions in cases of wasteful use of natural resources and environmental pollution.

While a reform of the fiscal system was being implemented, a new system of tax legislation was created, and its implementation began in 1995. The new taxation system was based on the Law “On Taxes and Duties”, enforced on 1st April, 1995. Several other tax laws came into force in 1995 e.g. “On Value Added Tax”, “On Company Income Tax”, “On Natural Resources Tax”, and some significant amendments to other tax laws. Most of these laws will be revised in the coming year. A revision currently under discussion is on how to change the transfer system of the revenues from income taxation in a way which would secure a more direct link between the collected revenues in each year and the amounts forwarded to each local authority.

The possibility of giving the local government a tax status with regard to real property tax, with the right of municipalities to set the tax rate within certain limits will be considered.

Table 4.2.1 Types of taxes and duties 1991-1995

No.	Item subject to tax or duty	Type of tax or duty 1991-1995	Type of tax or duty after 1995	
				Rate set by/beneficiary
1.	Company profit	Profit tax	Company (enterprise) income tax	state/state
2.	Property	Property tax	Property tax	state/ local governments/ non exist
3.	Revenue from turnover of certain types of goods	Excise tax	Excise tax	state/state
4.	Revenue from turnover of goods or services	Turnover tax	Value added tax	state/state
5.	Costs of salaries	Social tax	Compulsory social insurance contributions	state/state
6.	Land, used or owned	Land tax	Real property tax (including buildings and constructions)	state/local governments
7.	Income of inhabitants	Personal income tax	Personal income tax	state/ local governments and state
8.	Use of natural resources and pollution of environment	Natural resources tax	Natural resources tax	state/state
9.	Income from gasoline and diesel fuel sales and from power of mechanical and self-propelled vehicles	Road tax		
10.	Providing of certain legal and other services and activities	State and local duties	State and local duties	state and local governments/ state and local governments

National measures for revenue-efficient local tax administration

The rights to administer taxes are prescribed by the Law “On Taxes and Duties”, the Law “On State Revenue Service” and other laws.

The principal obligations of the tax administration are the following:

- to ensure that laws on taxes and duties are obeyed both by tax payers and the tax administration;
- to exert control over the calculation and paying of taxes/duties;
- to exert control over tax/duty arrears;
- to apply sanctions to those who violate laws on taxes/duties;
- to review cases when the paying of taxes/duties may be postponed, and decide in such matters;

- to control the compliance with the rules on tax benefits and exemptions from duties;
- to ensure publicity of tax/duty collection by publishing, on a regular basis, information about total revenue from certain taxes/duties, and about taxpayers who have incurred the largest tax/duty arrears;
- to publish information about changes in the procedure for setting the rates and imposing fines and sanctions for delayed payment of taxes/duties;
- to perform audits, control or checks concerning taxes/duties.

Table 4.2.2 Institutions of tax administration

No.	Type of tax	Administering institution
1	Personal income tax	SRS* and local governments
2	Company income tax	SRS
3	Real property tax	SRS and local governments
4	Excise tax	SRS
5	Value added tax	SRS
6	Natural resources tax	SRS, MEPRD** and local governments
7	Tax on lotteries and games of chance	SRS
8	Customs tax	SRS
9.	Compulsory state social insurance contributions	SRS

* SRS - State Revenue Service

** MEPRD - Ministry of Environment Protection and Regional Development

The State Revenue Service provides training of local tax inspectors (who are civil servants) and introduces a general IT system to modernise the system of tax administration.

In order to improve tax administration, the State Revenue Service provides training of civil servants (local tax inspectors), implements a general IT system in order to upgrade tax administration, and improves the existing tax legislation.

Local governments participate in the administration of the following taxes:

- personal income tax — the amounts of personal income tax of Riga, Liepaja and Ventspils inhabitants paid from the salaries of employees residing in the local government administrative territory are administered by Riga, Liepaja and Ventspils local governments themselves;
- real property tax;
- natural resources tax.

Tax administration in the Republic of Latvia is, currently, effective. The tax legislation system, however, is being improved in order to improve tax administration even further.

4.3 National regulation of the framework for non-tax revenues

Local government non-tax revenue is regulated by laws “On Local Governments”, “On Local Government Budgets”, “On Taxes and Duties” and “On Budgetary and Financial Management”, as well as by Cabinet of Ministers regulations “On the Procedure for Imposing Local Government Duties”, and other legislative acts.

The sources of local government non-tax revenue are the following:

- a proportion of state duties;
- local government duties;
- fines and sanctions;
- service fees;
- a proportion of the profits made by municipal enterprises;
- revenue from the leasing out and selling of municipal property.

The percentage of non-tax revenues per government group is show in Table 4.3.

Table 4.3 Percentage of non-tax revenues per government group

Non-tax revenue*	Regional Governments	Rural Authorities and Towns	Republican cities	Total
A proportion of state duties	0.30	1.62	1.26	1.38
Local government duties	0.06	1.55	2.33	1.81
Fines and sanctions	0.93	0.46	0.79	0.63
Service fees	70.65	35.50	84.71	59.60
Revenue from leasing out and selling of municipal property	9.72	7.62	2.63	5.52
Other non-tax revenues	18.34	53.26	8.28	29.96
Total	100.00	100.00	100.00	100.00

* Data from the Ministry of Finance report about the actual budgets of governments, 1999

The largest part of non-tax revenues that is allocated to the Regional government budgets is from service fees (70.65% from total non-tax revenues) and from revenues from the leasing out and selling of municipal property (9.72% from total non-tax revenues). This tendency is also similar for the rural authorities and towns, with 35.5% and 9.72%, respectively, whereas republican cities have 84.71% and 2.63%, respectively.

The Ministry of Finance forecasts the total amount of non-tax revenues for the fiscal year, using preferential macroeconomic developmental tendencies. This forecast is included in the Clarifications of State Budget Law and in the annual Dispute and Settlement Agreement between the Cabinet of Ministers and the Union of Local Governments.

Local Governments have the right to forecast non-tax revenues independently of the Ministry of Finance, therefore these forecasts differ. For example, in 1999, the Ministry of Finance made a prognosis of non-tax revenues of Ls 44.6 million, local governments made a forecast of Ls 42.3 million, but the actual figure was Ls 44.2 million.

Local governments have the right to introduce local duties and to determine their amounts, to make decisions about their rates and about exemptions from the payment of the duties, by issuing binding regulations.

Local government duties are paid to the respective local government budgets and are administered by the respective local government.

The State Revenue Service and the respective local governments administer the state duties that are fully or partly allocated to local government budgets.

Local governments plan their own non-tax revenues and also administer these non-tax revenues.

Local Government Administration Unit registers these binding regulations on local government duties, and controls the compliance of the regulations with the law.

Only an republican city's or rural authority's, town's council has the right to issue binding rules about the introduction of local government duties, and to demand payment for the following:

- use (lease) of land or other real property or movable property owned by the municipality;
- rent (lease) of housing and non-housing floor space;
- services of municipal water supply and sewerage;
- municipal heat supply;
- collection of domestic waste;
- issue of licences (permits);
- other services provided by municipal authorities or enterprises.

There are no controls on the amount of the revenue.

Local government duties

In accordance with binding regulations issued by the respective urban or rural municipal council, local governments may impose duties on the following:

- official documents issued by the republican city or rural authorities, town's municipal council;
- organisation of entertainment in public places;
- accommodation of holiday-makers or tourists;
- commercial activities in public places;
- the keeping of animals, wild or domestic;
- driving through special protection zones;
- placing advertisements, posters or announcements in public places, containing visual commercial information;
- keeping boats, motor-boats or yachts;
- use of municipal symbols for commercial purposes.

Local governments have the right to collect state duties for issuing special permits (licences) to engage in specific types of businesses. These duties are paid to local government budgets.

4.4 National policies on design of grants system

Local governments receive grants and earmarked grants from the state budget for the fulfillment of specific tasks assigned to them under the Law “On Local Governments” and under other specific laws. The government of Latvia is working on the medium –term budget preparation program, but today there are no binding documents that would stipulate multi –annually the amount of specific and general grants for the Local governments.

The earmarked grants are set annually at the national budget law.

There are following earmarked grants for municipalities:

- for salaries and compulsory social insurance contributions of teaching staff of local government primary and secondary general, professional and special educational establishments and partly for those of out-of-school institution teaching staff;
- for educational purposes in special pre-school establishments, boarding schools and sanatorium boarding schools, special boarding schools for children with physical and mental impairment;
- for supplementary earmarked grants received by local governments of regions and cities for salaries and compulsory social insurance contributions of teaching staff of primary and secondary general educational establishments for the purpose of implementing the Christian religion and ethics program;
- for salaries and compulsory social insurance contributions of professionals conducting the work of folk amateur groups;
- for investments;
- for physical planning and drafting and implementation of development plans.

The general grant to be received by local governments from the state budget are set annually at the national budget law and it includes grants:

- for the local government equalisation fund (calculated according to the Law “On Local Government Finance Equalisation” ;
- for the implementation of the law “On administrative territorial reform”.

Table 4.4 Division of General Purpose grants (millions of Ls)

Year	General purpose grants in Total	From that for the implementation of the Law “On Administrative territorial reform”	From that for the Local government Equalisation Fund	Local Governments contributions to the equalisation fund	Equalisation fund in Total
1998	11.2	-	2.7	24.3	27.0
1999	9.4	0.163	6.1	24.0	30.1

The amounts of general purpose grants and earmarked grants to be paid from the state budget are determined by the Law “On State Budget” which is adopted every year.

Grant for local government equalization fund

With a view of ensuring as much as possible equal conditions for all local governments in the implementation of their tasks, a special local government equalization fund has been created for the purpose of issuing equalization grants to local governments, the sources of revenue in this fund are state budget allocations and also contributions made by local governments.

The Law “On Equalization of Local Government Finances” of 5 March 1998 sets the procedure for financial equalization. The equalization system is based on objective criteria of balancing financial needs and costs.

In 1999 the amount of state budget grant to the local government equalization fund was Ls 6,103,010, and local governments contributed to it Ls 24,051,494. From the local government equalization fund local governments received grants amounting to Ls 30,154,504. The distribution of these resources according to local governments is determined each year by the Cabinet of Ministers Regulations, and the calculations are made by the Ministry of Finance.

Grant for increasing the revenue base of local governments

In order to ensure an increase in the revenue base of local governments, the Cabinet of Ministers submitted to the Saeima a proposal to amend the Law “On the State Budget of 1998”, and as a result the grant to be received by local governments was increased in the form of a Ls 3,420,142 grant to increase the revenue base of local governments. This grant was only allocated in 1998 under the Law “Amendments to the State Budget Law of 1998”.

Grant to local governments to compensate the uncollected real property tax revenue

It was planned to pay a compensation of Ls 4,500,000 to those local governments, which, for reasons beyond their control, have not been able to collect the planned real property tax revenue of 1998. This grant was also allocated only for 1998 under the Law “Amendments to the State Budget Law of 1998”.

Starting from the year 1999, municipalities have a grant for the implementation of the law “On administrative territorial reforms”.

Grant for the implementation of the law “On Administrative territorial reform”

In accordance to the law “On administrative territorial reform” the lump sum grant is allocated to these municipalities that have decided to amalgamate or co-operate for the implementation of their functions. Such grants are calculated up to five percent of amalgamated municipalities budgets or up to one percent of co-operated municipalities budgets.

During the year while the budget is drafted, negotiations are held between the Union of Local Governments of Latvia and the line ministries to discuss the necessary amount of grants and earmarked grants for the coming budget year.

The Ministry of Finance aggregates the minutes of these negotiations and prepares a final protocol showing the total amounts of tax revenue, grants and earmarked grants. This final document is then signed by the Chairman of the Union of Local Governments of Latvia and the Prime Minister, or Minister of Finance on behalf of the Prime Minister; the document is submitted to the Saeima together with the draft State Budget Law which has been reviewed by the Cabinet of Ministers.

The amount of the state grant to be paid to the local government equalization fund is calculated in compliance with the Law “On Equalization of Local Government Finances” as the difference between the total fixed amount of grants to be paid from the equalization fund and the total of contributions paid to the equalization fund by local governments.

The level of earmarked grants is fixed in accordance with the specific laws, but the amount of the grant earmarked for investments is determined after assessing investment projects of local governments.

Evaluation of the present system of grants

In 1999 the total budget revenue of local governments was Ls 444,390,659, including:

- basic budget revenues Ls 397,524,726, and
- special budget revenues Ls 46,865,933.

In the basic budget revenue of local governments the share of earmarked grants from the state budget was 23.4%, but the share of the general grant was 2.06%.

The present system of grants and equalization

The present system of grants and equalization in Latvia is based on the Law on Equalization of Local Government Finance adopted in Saeima on March 5, 1998. This Law was in force already from the financial year of 1998.

The system contains regulations on expenditure need as well as revenue equalization and a system based partly on municipal payments (the major proportion) and partly by general state grants. The share financed by the municipalities themselves constitutes presently the biggest part, but this has varied from 1995-1999. The system contains a number of new and approved articles and is a reform of the first basic system of 1995.

The equalization of the local government expenditure and revenues is done for the three types of local governments separately, i.e. 1) republican cities (the big cities), 2) rural governments and 3) regions (26).

The equalization of the expenditure needs and the revenues are done in an integrated way, where the point of the departure is a comparison of the expenditure needs with the revenue side in each of the 586 local authorities. The local authorities with an revenue basis higher than 10 % more than the calculated expenditure needs contribute to the system with 45% of that surplus (although not more than max. 35 % of the revenues of that local authority). The local authorities with a revenue below 100 % for the regions, 95 % of the calculated expenditure for the republican cities and 90 % for the regional town/rural districts receive a grants from the equalisation fund to bring them up to respectively 100 %, 95 % and 90 % coverage of their expenditure needs.

The ceilings mean, that local governments between respectively 100%, 95% and 90 % according to the type of the local governments and 110 % of the expenditure needs covered by the revenues do not contribute or receive grants from the system (a so-called neutral zone with no payment of receivements).

Expenditure need equalisation

The system of expenditure need equalisation is based on the following main criteria for equalisation:

- The type of local government (republican city, region or rural area)
- The number of inhabitants

- The number of children from 0-6 years old
- The number of children from 7-18 years old
- The number people above the working age
- The number of children in children's homes
- The number of elderly people in old people's homes and centres.

The first five criteria are real "objective" criteria, i.e. that the local governments cannot influence the criteria themselves, whereas Nos. 6 and 7 are quasi objective criteria as these criteria are based on the number of the children and the number of elderly people in homes for elderly people (who have stayed there before Jan. 1, 1998). The last two criteria were developed in order to adjust for the fact that some local authorities have many of these children and elderly people due to special huge service centres from the past (communist) system of services provision. In fact these criteria only have a weight for rather few local authorities, cf. below.

Revenue equalisation

Two types of tax revenues are included in the system:

1. Income tax
2. Real property tax

These types of taxes constitute the major share of the local government tax revenues (i.e. in accordance with the Council of Europe's recommendation).

The system of equalisation is based on estimates for these taxes made before the year of the equalisation and the local authorities pay or receive according to these estimates. There are no later adjustment of the grants and equalisations in a situation where the estimated tax is higher or lower than the prognoses.

On the other hand, the local authorities are guaranteed the estimated revenues by the central government regarding the prognoses for income tax and real estate taxes (regarding real estate taxes only for the year 1998).

Administration of the system

All calculations within the system of grants and equalisation is made by the Ministry of Finance and the figures are based on inputs from a number of institutions, e.g. the State Citizenship and Migration Office, the State Revenue Service, State Land Service and the local governments.

The State Treasury conducts the administration of the transfers to and from the local governments. Three local governments, Riga, Liepaja and Ventspils have a special system of taxation, where the tax administration is carried out by the local authorities themselves. These local authorities forward their contributions (transfers of surplus to the system of equalisation) to the State Treasury on a regular basis.

The State Treasury forwards the payment and the equalisation grants (+/-) twice a month to local authorities.

Establishment of the Local Government Equalisation Board

In 1995, a local government equalisation board was established to discuss matters of local government finance and equalisation, including state grants. This Board, which has undergone minor changes, consists today of 5 representatives from the local governments and 5 from the central government and one for the Parliament (laid down in the Law on Equalisation). The Board has independent competencies within some areas, e.g. intermunicipal payments, and deliver advises to the Cabinet of Ministers within other areas of grants and equalisation.

Evaluation

The present system has the following advantages

- The system considers the huge differences in the local government revenue basis in Latvia.
- The system contains an expenditure need calculation and revenue equalisation, which are rather stable from year to year. The prognoses are not changed during the year and there are few discussions during the year on the statistical data etc. This creates certain stability, which was lacking before.
- The new Law of March 5, 1998 is the first general law, which lays down the main principles for equalisation, i.e. these principles do not have to be discussed every year and this enhances the stability. The previous laws only covered a fixed year and this created certain instabilities.
- A strong system of equalisation is needed in most countries but especially in Latvia, where the differences in revenue capacity among the local authorities are much higher than in other countries. Some local authorities in Latvia have up to 10 times more tax revenues per inhabitant than others
- The system supports the less wealthy local authorities, i.e. local authorities with a high expenditure need compared to their revenues. This secures the possibilities for certain equal possibilities for service provision, although the system does not secure equal possibilities. The system takes the relationship between the expenditure needs and the revenues into consideration, i.e. the possibilities for financing the present local government tasks. This support has been weakened the latest years
- The system is stable in terms of securing the major estimated revenue sources, i.e. the state grants, the income tax and the real estate tax.
- The stronger local authorities contribute to the system, although the level varies from municipality to municipality, cf. below. Generally, the local authorities contribute with the largest share themselves.
- The administration of the system is stable, well organised and the transfers timely and regular, except regarding the transitional period before the new regulations are adopted. The system has a stable inflow of money and the combined administration of the revenues from taxes and the equalisation scheme secures sufficient amount of resources in the fund (except in transition periods, cf. below).
- The Equalisation Board with representatives from both the central and local governments has a number of clear advantages, e.g. secures qualified input and good basis for the decisions regarding the system of grants and equalisation, secures an open dialogue about the problems and challenges within the field and strengthens the co-operation between the central and local governments in the field of local government finance.
- Rules on inter-municipal payments have been established. These rules are enforced by the Board in situations where the local authorities refuse to pay for the use of services in the neighbour local authorities. These rules are comparably clear and the sanctions well developed, but could be strengthened in the future, cf. below.

- The guarantee for transfer of revenues in accordance with the estimates for personal income tax and real estate tax (only for year 1998) secures a stable situation for the local governments in their budget process. The guarantee is only one way, i.e. the local authorities are guaranteed to receive revenue at least according to the estimated revenues, i.e. if more revenues are collected, more revenues will be transferred to the local authorities.
- The system is based on a sound principle that money follows the number of varying types of inhabitants and not the specific institutions. This protects the local government autonomy in the decisions regarding the establishment of the right mix of services according to needs within the area (the local priorities and discretion on the expenditure). Systems based on payment according to number of specific infrastructure facilities, e.g. number of schools and kindergartens can create artificial services/not needed infrastructure. In such a situation there might be an attempt by the local authorities in order to attract extra funding to direct the service provision to specific areas where the state grants will be higher.
- The revenue equalisation (45% for the local authorities above the average and max 35% of the tax revenues) is not too high for the incentives to create wealth within the local areas. This might be a problem for the local authorities below the average revenue per capita, cf. below.
- The Equalisation Board has a number of advantages and deliver input to the decisions and qualified input to MoF.

Disadvantages of the present system

Although the present system represents a clear step forward there are a number of areas with potential improvements.

The most severe problem in the present system is the calculation of the total expenditure needs each year before the coming financial year. This figure has a decisive role for the system of equalisation as it is used as the basic for the calculation of the needed grants. There is a lack of detailed calculations of the exact expenditure needs at the local government level.

The present criteria should be evaluated in order to have a more updated review of the relationship between the cost area, e.g. costs areas for children between 7-18 years, and the population group. The present weights are based on old figures for the distribution of cost across these expenditure groups. However, also in future we will have both: income and expenditure part equalisation. Reporting system on Local government's budget data becomes better with every year. The officials from the Ministry of Finance that are responsible for the Equalisation algorithm are ready to recalculate criteria weights of expenditure need (methodology is clear) but the government has an agreement with the Union of Local Self governments not to make any amendments at the law "On equalisation of Local Government finance" for the year 2001. Therefore, there is a plan to re-evaluate criteria weight together with the Union of Local Self Governments for the year 2002 and to make necessary amendments at the law "On local government finance equalisation".

Some local authorities have up to 10 times more revenues from taxes per inhabitant than others before equalisation. This makes it difficult to make a sufficient strong equalisation, especially with the maximum level of equalisation, i.e. 35% of the tax revenues. This is not a problem caused by the system of equalisation itself but will need to be addressed in the aim to develop a local government territorial reform and the related financial reforms, cf. below.

A reform of the system of equalisation is needed if and when a territorial reform changes the present division of tasks considerably. On the other hand an appropriate territorial reform will ease some of the

problems mentioned above, e.g. probably some of the huge variations across the local authorities on revenues per inhabitant. The reform of the system will therefore be seen in close connection with this reform, e.g. the future functions and competencies of the regions.

4.5 National control on borrowing

Authority to borrow or grant loans

Only the Minister of Finance may handle matters relating to state borrowings or granting of loans within the limits of the Annual State Budget Law.

Heads of budget institutions have no right to borrow or conclude leasing contracts on behalf of their institution with credit institutions or other institutions, unless an agreement concerning the matter has been reached with the Minister of Finance.

Local government borrowings

The legislative framework for local government borrowing was changed substantially over the past years. Initially, local governments were allowed to borrow from the lender of their choice, subject to certain conditions. Then the framework was strengthened in 1996 – 97 with a detailed regulation, which introduced a yearly cap on borrowings and guarantees to be determined by annual State Budget law. The creation of the Local Government Borrowings and Guarantees Council in 1996, was another imported step.

Legislation and rules on local government borrowing

The following laws and regulations regulate the local government borrowing:

- Law “On Local Government Budgets”
- Law “On Budget and Financial Management”
- Law “On State Budget”
- Law “On Local Governments Finance Stabilisation and Local Governments Finance Supervision”
- Regulations from the Cabinet of Ministers on Loans and Guarantees

The government of Latvia observes strict financial and fiscal policy and the annual debt level for the municipalities is limited and is stated in the annual law on national budget. The ceiling for 1999 was 30 mill. lats (the same as for 1998). The amount for the year 2000 being 17 mill. lats where 10 mill. lats of the total amount was for borrowing (and from that 0.5 mill. lats was for the stabilisation of local governments finances) 7.0 mill. lats are for guarantees. Along with the financial resources that are denominated in the national currency, and State Treasury can lend to the municipalities on favourable terms, with comparatively easy and fast procedures and without foreign exchange rate risk, the government has arranged credit facilities with the European Investment Bank and with the Nordic Investment Bank for the local government’s long term borrowing purposes. The Local Governments borrowing procedures are strictly observed by the Local Governments Borrowings and Guarantees Board. Without permission from this Board Local Government has no right to borrow. If Local government wants to borrow from other sources than the State Treasury, special permission from the Minister of Finance is requested.

Control and supervisory body

In 1996, a local government borrowing supervisory body ("Board") was set up, based on a Regulation from the Cabinet of Ministers. The Body has functioned unchanged until today. The body consists of the following members:

- Ministry of Finance
- State Treasury
- Ministry of Economy, Department of Investment
- Ministry of Environment Protection and Regional Development
- Local Government Administration Unit
- Union of Local Self Governments (ULSGL)
- Latvian State Bank.

The council elects its chairman among its members. This Board plays a key role in all-local government borrowing and guarantees. All local government borrowing and guarantees have to be approved by this Board. If municipalities apply for State Treasury loans, the Board makes the final decisions on whether an application should be approved. If municipalities prefer to have a loan from another credit institution in addition to the Board's approval the permissions from the Minister of Finance have to be obtained.

The administration of the Board is under the auspices of the Ministry of Finance (from March 1998 where it was transferred from the Local Government Administration Unit).

The decisions of the Board are taken after comments from experts, e.g. from local governments and after receivment of a local government borrowing application from the local authorities.

The Board has a considerable power on regulation and supervision of local government borrowing and guaranties, including approval of these, which is delegated from the Cabinet of Ministers. The full Cabinet of Ministers and not the minister of finance can revoke the decision taken by the Board.

Criteria for evaluating the financial capacity for loans

The Local Government Borrowing Board evaluates every application on borrowing and guarantee by evaluating the local governments ability to repay the loan, the capacity to administer the finance etc. In this evaluation the following criteria is used:

- The possibility to administer the project
- The previous local government borrowing
- The general loan bracket
- The documentation of the rentability, e.g. business plan and strategic planning
- The size of the loan compared to the local government economy

Statement of opinion may be asked from various experts, e.g. the Building Board, different ministries etc.

The local authority forwards an application to the Board including a statement on the economy, purpose of the loan, repayment documentation and business plan.

The sector areas are not included in the criteria. It is supposed to be up to the local authorities themselves to decide which areas they want to invest in.

There is a special stabilisation fund for local authorities with severe economic problems that need bail out procedure. The bail -out procedures are regulated with the law “ On Stabilisation of Local Governments Finance and Local Governments Finance Supervision”. There are no strict limitations on further Local Governments borrowings. The Commission for the Local Governments Finance Stabilisation will evaluate for which purposes stabilisation loan is requested. Normally such loan would cover non- paid debt, non-paid amount of taxes, and it could cover additional investments if it will insure lower current costs or if it is for urgent need like water treatment etc.

Two municipalities in year 1999 and in addition three municipalities in year 2000 enter a special arrangement with the Ministry of Finance, including a plan for restructuring of the economy, appointment of a supervisor, agreement on special loans etc. 0.5 mill. lats was set aside for this purpose in 1999. These special loans may be soft loans or direct grants. Today we have only direct loans. These local authorities are closely supervised and special agreements are made between the Ministry of Finance and these units.

Scope of loans

The loans can be approved for various purposes, but the purpose, mentioned in the application for the loan, should be fulfilled. Some loans should be used on the stabilisation of the economy, cf. above. Other may be used on short - term purposes such as purchase of fuel, materials etc. in time where these have a competitive price. Other may be used in period of time where the tax revenues are lacking or postponed other for investment etc. There are no fixed rules on that, but each case will be evaluated by the Body. There are no restrictions on the sector areas.

Guarantees

All guarantees issued by the local authorities have to be approved by the Board. Local authorities have generally access to make guaranties if they own a local enterprise or at least more than 50 % of the shares in an enterprise. In a case of joint municipal enterprises local authorities have a right to guaranty if they own a local enterprise or at least more than 65 % of the shares in an enterprise. In this situation each municipality can guarantee respectively to the amount or portion of their shares in the municipal enterprise.

Place for borrowing

The general rule (No. 64, Cabinet of Ministers) is that the loans are obtained from the State Treasury. The loans from the State Treasury are based on the interest rate on the State Bonds to the commercial banks +0.5% in administration fees.

Loans can be obtained from other sources but this demands that the local authority can prove that the conditions, i.e. the interest rates, are lower than those of the State Treasury. These applications should be forwarded to the Board, which delivers advice to the Minister of Finance for the final decision. This has just been the case for 8 local authorities which wanted to borrow abroad from a foreign fund, at 3-5% interest rate. In theory, loans can also be obtained from commercial banks, but this again demands that the conditions are better than the State Treasury, which is not the case at the moment, and that the Minister of Finance approves this. Access to foreign borrowing exists, but only after these conditions are met, i.e. better terms and approval from the Board.

The local government cannot go directly to the commercial banks (opposite to the situation in 1996), but have to go through the Central Government.

Local government enterprises are a special case, as they can take loans everywhere, but not from the State Treasury.

Duration of the loans

There are no restrictions on the duration of the loans. In practice the State Treasury issue 10 years loan (one year of grace period), the World Bank 17 years loan (5 years of grace period) and the Nordic Investment Bank 25 years loan (10 years of grace period). Again the terms of the loans have to be approved by the minister of finance, if other sources than the State Treasury are used.

In general loans for current expenses are only short-term loans, except loans for stabilisation of the economy. Long-term borrowing usually finances capital investments (more than 1 year).

In the table below you can find a indebtedness of municipalities: local net debt from 1997 to 1999.

Table 4.2 Indebtedness of municipalities: local net debt, 1997, 1998 and 1999 (in million Ls)

	1997	1998	1999
General government deficit/ surplus	40.45	5.14	-155.93
General government gross debt	-	-	-
Local government deficit/ surplus	-3.76	-14.10	-15.07
Local government gross debt	-	-	-
Local government deposits and securities	-	-	-
Local government net debt	-	-	-

The data on general government deficit shows state consolidated budget deficit. State consolidated budget includes municipal consolidated budget (special + basic) and central government consolidated budget (special + basic). The data on local government deficit show figures on municipal consolidated budget (special + basic). Information on municipal debt is available from the year 2000.

4.6 Local discretion- Expenditure

The basic principle for the division of functions:

Article 15 of the Law on Administrative-Territorial Reform adopted by the Parliament on 21 October, 1998, established the use of the subsidiary principle:

“When determining the division of the functions between the state administration institutions, regional governments and local governments, the subsidiary principle is observed, which determines that the institutions of a higher level have to perform only those functions which are not possible to give to, or which cannot be effectively performed by, the institutions of a lower level”.

The subsidiary principle is also part of the European Charter of Local Self-Government, which Latvia has ratified.

Rural authorities and Towns’ tasks:

According to the subsidiary principle, the rural authorities and towns should perform as many tasks as possible because they constitute the lowest local government level.

In the first years after independence, many tasks were decentralised to the local governments. The current Law “On local government”, article 15, stipulates 17 permanent tasks for rural authorities and towns and 4 permanent tasks for the regions (Rayons). The permanent tasks of the 7 “republican cities” are those of both rural authorities and towns and the region – in total, 21 permanent tasks.

Apart from the permanent tasks, the rural authorities and towns are also responsible for a number of temporary tasks (laid down by laws and regulations) and voluntary tasks.

Local and regional governments have the following permanent functions:

1. to organise the provision of public utility services for the inhabitants (water supply and sewerage, heat supply; collection, disposal, storage or recycling of domestic waste; collection, disposal and treatment of sewage water);
2. to be responsible for the improvement of, and sanitary condition of, their administrative territory (laying of streets, roads and arrangement of squares, their restoration and maintenance; lighting of streets, squares and other territories of public use; planting and maintenance of parks, green squares and other green areas; control over collection and disposal of industrial waste; taking anti-flood measures; opening and maintenance of cemeteries and places for burying dead animals);
3. to establish rules for the use of public water and forests, unless another procedure is prescribed by law;
4. to be responsible for the education of the inhabitants residing in their territory (ensuring that the inhabitants may exercise their right to primary and general secondary education; provision of places for children of pre-school and school age in educational institutions; provision of organisational and financial assistance to non-school educational institutions and institutions supporting education, etc.);
5. to be responsible for giving support to culture, and the preservation of traditional cultural values, as well as giving support to people’s cultural activities (organisational and financial assistance to cultural establishments and activities, to the preservation of cultural monuments, etc.);
6. to guarantee the availability of health care and to promote a healthy lifestyle;
7. to ensure social assistance (social care) to inhabitants (social assistance to low income families and socially vulnerable people, provision of places in old people’s homes, provision of places in educational establishments and homes for orphans and children left without parental care, provision of night shelter for homeless people, etc.);
8. to be responsible for matters of guardianship, trusteeship and adoption;
9. to give housing support to inhabitants;
10. to encourage business activity in their administrative territory and to take measures to decrease unemployment;
11. to issue permits and licences for entrepreneurial activity, if so provided by legislation;
12. to maintain public order, to fight against the abuse of alcohol and against moral degradation;
13. to plan the building development in its area, in compliance with the development plans of their respective administrative territories;
14. to monitor building activity in their respective administrative territories;
15. to keep the Civil Register;
16. to collect and issue data required for national statistics;
17. to organise the election of lay judges and take the necessary measures for holding the local government elections in the relevant urban (town/city) or rural (*pagasts*) area;
18. to participate in civil defence;
19. to organise public transport services;
20. to ensure their representation in the regional Sickness Insurance Fund;
21. to organise the further education of pedagogical staff, and methodology work in the field of education.

The functions referred to in items 1-18 are fulfilled by rural authorities and towns, those referred to in items 18-21 are the functions of regional governments.

However, the functions mentioned in items 1-21 all come under the responsibility of the republican cities.

According to a survey made by the Union of Local and Regional Authorities in Latvia (ULRAL), the total list of permanent, temporary and voluntary local government tasks includes more than 100 tasks but many are not clearly allocated to a particular level of government.

For instance, social security is traditionally a state task but it was partly taken over by the local governments, in 1991. However, not all local governments had the ability and resources to carry out the task, so, since 1993, the Ministry of Welfare has introduced several regulations which take back parts of the responsibility for the social area to the state level thus resulting in a very unclear division of tasks.

A specific problem is that many laws only mention that “self-governments are responsible for the implementation of certain tasks”. It is unclear whether the local governments (town and pagasts) or the regional governments should carry out these tasks. To a wide extent, the division of these tasks (e.g. leisure activities for children) depends on the abilities of the regional and local governments in the region, and personal initiatives from politicians or administrative employees. Therefore, the current division of these “self government tasks” differs considerably from region to region.

Regional tasks:

(1) The permanent tasks of the regional governments are described in the “Law on local government”, article 15:

- Participation in civil defence.
- Organisation of public transportation.
- Representation of self governments (local and regional) in the regional sickness insurance institution.
- Organisation of the development of the education level of pedagogical employees, and the methodology of educational activities.

As can be seen, the regional permanent tasks are very limited, but most of the regions perform a considerable number of voluntary tasks and, to some extent, support the weaker local governments with the implementation of their tasks.

As mentioned above, the responsibility for the health-care system was transferred from the regional level to the state level, in 1997. This also led to a re-division of personal income taxes as follows:

Year	State	Region	Local
1991-1997	0%	15%	85%
1998	29%	0%	71%

The tax reform meant an increased dependency for the regional governments on various types of state grant which today constitute approximately 90% of the regional budgets. As for the local governments, the dependency on state grants makes the regional governments vulnerable to change and hinders long-term planning. These financial conditions negatively influence the way in which regional tasks are carried out.

National mandates for arranging the sub-national services

Local and regional governments function independently within the limits of their competence and in compliance with the provisions laid down by legislation. A Ministry, as established by the Cabinet of

Ministers under the Law “On Local Governments”, supervises their activities. At the moment, it is the Local Government Administration Unit, which carries out this supervision.

The State Audit Office supervises the way municipal councils manage their finances and property.

The municipal council is responsible for the organisation and fulfilment of the permanent functions. The costs of the tasks within the permanent functions are financed from the local government budget, unless otherwise prescribed by law.

Municipal councils have full autonomy, and they adopt their own budgets independently, in compliance with the existing laws and other legislative acts.

In general, there are no output controls of local government service provision. The local governments are free to provide services in accordance with the law, structure the provision of services, etc. There are very few norms within some sector areas, e.g. education, welfare and environment, and, in general, the local government decides the service level.

Local Government Administration units control the legality of local governments but not the appropriateness of local government decisions or the organisation of their service provision. Local governments are audited both internally i.e. by bodies appointed by the local authorities themselves and by the State Audit. This audit mainly concentrates on legal aspects and whether funding is used in accordance with the budgets and special requirements in the legislation.

Relations between local governments and the state are, first and foremost, manifested when the state adopts a law on local governments or relating to local governments to a greater or lesser extent. The state allocates general grants and earmarked (special) grants.

Secondly, relations between the state and local governments are seen in the distribution of functions. There is a tendency to reduce the share of state functions by delegating part of these to local governments and the private sector.

Under the Law “On Local Governments” and in the procedure prescribed by legislation, local governments are subject to supervision by state administration institutions and their officials, which may only put restrictions on local government activities in cases prescribed by law. The lawfulness of decisions taken by municipal councils is supervised, but not the effectiveness of such decisions.

National mandates for the provision of the sub-national services

The competence of local governments in the sphere of public rights, as prescribed by Law “On Local governments”, may be divided into three categories:

- compulsory functions
- functions delegated by other local governments through agreements, and
- voluntary functions.

Municipalities independently prepare, approve and manage their budgets, as well as make decisions on the expenditures. However budget expenditures of the municipalities in the financial year shall not exceed the total amount of estimated revenue for the respective budget year plus the balance of previous year funds.

Budget expenditures of municipality are approved along with its annual budget. The Budget expenditures of municipalities should be up to sufficient amount to manage its permanent functions.

The special grants within the state budget must be used only for special goals. For example, subsidies for increase of the teachers' wages must be used just for teachers' salaries. State control and certified auditors make audit on expenditure of these subsidies and give audit report on the local governments budget expenditures. The local government can receive the subsidies for specific investments only by submitting to the State Treasury the payment order issued on works.

Municipal councils have the right to make independent decisions within the limits set by laws and other legislative acts.

A municipal council has the right to review any matter that falls within its responsibility but only a City/Town Council, or a Rural Municipal (*Pagasts*) Council may:

1. adopt its regulations;
2. adopt its budget plan, introduce changes in the budget plan and approve the budget reports;
3. adopt the social and economic development plan of the municipality and the physical development plan (master plan);
4. make decisions about the elimination of administrative divisions, changing its borders or renaming an administrative territory;
5. adopt the economic or social development programmes of the municipality and long-term programmes of environmental protection;
6. change the administrative division of its territory and its administrative structure;
7. establish the symbols of the town/city or rural municipality (*pagasts*) in conjunction with the State Heraldry Commission of Latvia;
8. establish, re-organise or close local government institutions and municipal enterprises, approve regulations of local government institutions and Charters of municipal enterprises;
9. appoint and dismiss heads of local government institutions and managers of municipal enterprises, as well as other officials, as provided for by the laws and regulations of the local government;
10. elect or dismiss (remove from office) the Chairperson, Vice-Chairperson, members of permanent Committees and members of the Audit Committee of the City/Town Council or Rural Municipal (*Pagasts*) Council;
11. appoint and dismiss its Executive Director;
12. fix the amount of remuneration of the Council members and the procedure for remunerating them for the fulfilment of their duties and for reimbursement of their expenses arising from the fulfilment of their duties;
13. fix the rates of salaries payable to the Chairperson, Vice-Chairperson, the Council staff members of the local (town/city or *pagasts*) government and the heads of local government institutions;
14. fix the rates of payments for the following, unless prohibited or established by laws or regulations issued by the Cabinet of Ministers :
 - the use (under lease contracts) of land or other real or immovable property owned by the municipality,
 - the rent for housing and non-residential floor space,
 - the use of the local plumbing lines,
 - the heat supply provided by the municipality,
 - the collection of domestic waste,
 - the issuing of licences (permits),
 - other services provided by the local government institutions and enterprises;
15. take decisions concerning the collection of municipal service fees which are binding upon the inhabitants, and fix the rates of taxes if so prescribed by legislation;
16. issue regulations about public order and establish liability for violation of such regulations as binding upon the inhabitants;
17. make decisions concerning expropriation, mortgaging or privatisation of municipal property, and the acquisition of real property by the municipality;

18. make decisions about the use of first refusal rights concerning real property offered for sale on the territory of the municipality;
19. establish the procedure for conducting transactions with real property owned by the municipality, including the procedure for the acceptance and supervision of donated and inherited property, guaranteeing loans and credits, and the assumption of other types of economic liability on behalf of the local government;
20. assign names to streets, parks and squares and rename them;
21. suspend and cancel decisions taken by local government institutions;
22. cancel instructions issued by the Chairperson of the Town/City Council or Rural Municipal (Pagasts) Council;
23. set the procedure concerning the fulfilment of functions referred to in item 15 and the procedure for appointment of people responsible for the fulfilment of these functions, as well as the procedure for submitting the relevant progress reports;
24. elect representatives and members of the local government for participation in local government committees or Government committees, commissions and working groups;
25. take decisions related to the organisation of elections and public referendums in compliance with the procedure set by the Central Election Commission;
26. elect lay judges, chief judges and members of custody courts, rural (Pagasts) courts and housing courts;
27. take decisions in other cases, as prescribed by law.

A City/Town or Rural Municipality (Pagasts) Council should be able to justify any decision it takes to the greatest degree possible.

The Riga City Council may delegate a review of matters referred to in items 9, 18, 21, 24 and 27 to a local government institution established by the Riga City Council.

Under Article 82 of the Law “On Local Governments”, regional councils shall arrange the fulfilment of their permanent functions and the functions delegated to them by local governments, and, in cases provided for by law, fulfil the obligations associated with the functioning of educational, health care, social assistance and cultural institutions belonging to municipalities of regional towns and pagasts, as well as providing methodological support to such institutions.

Regional councils may review any issue in their competence, but only regional councils are entitled to do the following:

1. approve the regulations of the Council;
2. adopt the council budget, make amendments to the budget and report about budget implementation;
3. approve social and economic development plans of the region and the physical development plan;
4. make proposals and issue opinions concerning the elimination of some administrative division of its territory, the changing of administrative borders or the renaming of an administrative division;
5. approve long-term programmes of social and economic development, and environmental protection programmes of the region;
6. establish the symbols of the region in conjunction with the State Heraldry Commission of Latvia;
7. reorganise and dissolve establishments set up by the relevant regional council and establish new enterprises for the fulfilment of regional government functions; approve regulations of establishments and Charters of enterprises set up by the regional council;
8. appoint and dismiss managers of establishments or enterprises set up by the regional council, or other officials, as provided by law or the regulations of the Council;
9. elect or release from fulfilment of duties the Chairperson of the Council, Vice-Chairperson, Committee members, and members of the Audit Committee;
10. appoint and dismiss its Executive Director;

11. set the amount of remuneration for fulfilment of the duties of a council member and the procedure of payment of this remuneration and reimbursements of expenses arising from the fulfilment of such duties;
12. set the rates of salaries of the Council Chairperson, the Vice-Chairperson and the Executive Director;
13. impose municipal (local government) duties in cases provided for by law and, if not prohibited or already established by law or Cabinet regulations, set the amount of fees for the services provided by establishments or enterprises set up by the regional council;
14. enforce binding rules and impose administrative sanctions for the violation of such rules;
15. make decisions about the transfer of real property owned by the regional council or the acquisition of real property by the regional council;
16. set the procedure for conducting transactions with movable property owned by the regional council, and the procedure for accepting and supervising donated or inherited property, loans, credits and the assumption of other economic liabilities on behalf of the regional council;
17. suspend or cancel resolutions issued by the managers of the establishments set up by the regional council;
18. cancel orders issued by the Council Chairperson or Executive Director;
19. make decisions concerning the procedure for fulfilling the functions provided for by the above Law, Article 82, and appointment of persons responsible for the fulfilment of the functions, and the procedure of reporting about implementation;
20. take decisions related to the organisation of elections and referendums under the procedure established by the Central Election Commission;
21. take decisions in other cases provided for by law.

In Latvia, local governments have no right to set tax rates because the existing taxes are state taxes. Local governments only have the right to impose those duties referred to in Article 12, paragraphs 1 and 2, of the Law "On Taxes and Duties":

(1) In the procedure established by Cabinet regulations, an urban (town or city) municipal council or a rural (pagasts) municipal council has the right to impose duties in its respective administrative territory on the following:

1. issue of official documents or certified copies of the documents produced by that urban or rural municipal council;
2. organisation of entertainment in public places;
3. accommodation of holiday-makers and tourists;
4. selling of goods in public places;
5. keeping of animals, domestic or wild;
6. driving through specially-protected zones;
7. placing of advertisements, posters or announcements in public places;
8. keeping of boats, motor-boats or yachts;
9. use of municipality symbols;
10. issue of a building permit.

(2) In the procedure set by Cabinet Regulations, a regional council has the right to impose duties in its respective administrative territory on the following:

1. issue of official documents or certified copies of the documents produced by the regional council;
2. use of regional government symbols.

Local governments may freely fix the amount of remuneration for the fulfilment of the duties of municipal council members and the procedure for paying this remuneration and the reimbursement of expenses arising from fulfilling the obligations of a municipal council member. Local governments may freely fix the rates of remuneration of the Chairperson, Vice-Chairperson, Executive Director and other staff

members of the municipal council. The minimum amount of such remuneration must not be lower than the officially fixed minimum salary in the country. The local government is free to recruit its own staff within the set financial limits.

4.7 General budget co-operation with central government

The Law “On Municipal Budgets”, the Law “On Budgetary and Financial Management”, the Law “On Local Governments”, tax laws and other legislative acts set the budget rights and independence of municipalities, as well as their relations with the state budget and the budgets of other municipalities.

Municipal councils draft, adopt and implement their budget plans independently. State institutions are not allowed to interfere with the drafting and implementation of local budgets unless prescribed by law. The regional self-government institutions have the right to participate in drafting and implementing city or rural municipality budgets only in cases prescribed by law and in observance of the set procedure. In practice, a regional self-government does not have the right to interfere in another government’s budget.

The Minister of Finance has prescribed a standard classification for the recording of local government budget revenue, expenditure and debt, and has established rules for budget accounts. Local government budget plans must always be balanced.

In accordance with State Treasury instructions, all the financial activities of the municipal councils are registered in the official local government financial accounts. The local government budget for the current budget year includes all the revenue collected or received by the local government (and its institutions) which is then used by the local government to achieve its goals.

Municipalities budget preparation and reporting system is getting better with every year. Budget revenue and expenditure classification and the local government’s budget reporting forms that are issued by the Ministry of Finance and the State Treasury are getting improved. The legislation is improved by preventing contradictions within and overlapping of some legislative norms.

The Local Government Management and Finance project was implemented in year 2000. As a result of the project the handbook “Municipal financial management manual” was prepared assist municipalities in the budget preparation and reporting.

The distribution of revenue between the state budget and the local government budgets, and also the equalisation between the state budget grants and the equalisation of economic potentials among their territories, is prescribed by laws regulating the revenue, special laws, or the annual State Budget Law.

A main characteristic of the instruments for the central control of expenditure

The budget is a means of implementing the policy of the state by financial methods.

The purpose of the budget is to determine and justify the amount of resources required by the Government and other state institutions and *local governments* for the fulfilment of the obligations assumed by the State, the financing of which is regulated by legislative acts, ensuring that during the time period for which the resources are allocated, the expenditure should adequately be covered from revenue.

The State Treasury, in conjunction with the State Revenue Service, monitors the due and timely receipt of all revenue by the State budget, and ensures that the State budget expenditure complies with existing legislation.

The local governments, following directions and instructions issued by the State Treasury, submit detailed accounts and reports concerning the amount of all revenue, expenditure, borrowing and special budgets.

Payments made to the local government budgets are ensured and supervised by the State Revenue Service.

The conformity of drafting and implementing local government budgets in accordance with existing legislation, regulations issued by the Cabinet of Ministers and the decisions taken by the relevant municipal councils, are controlled by State Audit Office. At least once a year municipalities have to invite registered auditors or audit companies to perform this task

If the Saeima passes a law, or the Cabinet of Ministers issues regulations after the enforcement of the State Budget Law, and such new legislation leads to an increase in the expenditure or decrease in the revenue of the local government budgets, the sources of state financing must be indicated in the new law or Cabinet Regulation to cover the increase in the expenditure or the decrease in revenue of the local government budgets. In practice, these procedures are not always followed .

If the Saeima passes a law, or the Cabinet of Ministers issues regulations, after the approval of the State Budget Law, and such new legislation allows for a decrease in the expenditure and the increase in the revenue of the local government budgets, the surplus gained from this may be allocated to the needs of the State or the local governments in accordance with the procedure of State budget appropriation. Under the Law “On Budgetary and Financial Management”, no financial obligation may be imposed on local governments after the adoption of the state budget unless the sources of revenue are indicated and granted by the Government for the fulfilment of the new task.

The total framework, i.e. the total financing of local government expenses for the coming year is set after negotiations between the central and local governments in the yearly protocols. These protocols contain the total local government expenses, revenue, state grants and revenue composition.

Local governments have the right to collect taxes and duties imposed under the existing legislation and to draft independently their own budgets. In actual fact, local governments only collect real property tax, which is paid directly to the local government by taxpayers. The State Treasury distributes personal tax revenue. The State revenue service is responsible for collecting all the other taxes. Both the tax base and the tax rate are set by central government for all the important taxes. In this way, the central government has a decisive influence on the total financial framework of the local government sector.

Local government budgets may be regarded as a plan for how to achieve the established goals using the local government’s potential financial resources. The aim of local government budgets is to determine and show the justification for the amount of resources required for the fulfilment of local government functions delegated to it by legislation and for the fulfilment of voluntary functions. Budgeting and the use of budget resources are transparent processes and generally there is very limited interference from the central government in these processes.

Urban and rural municipal councils organise the implementation of local budgets, ensure the collection of taxes and the use of the available resources in compliance with the existing legislation and in conformity with general regulations issued by the Cabinet of Ministers and the Ministry of Finance.

Local government budgets may be assigned only for the purposes stated in the budget plan adopted by the respective municipal council. The amount of the resources assigned must not exceed the amount planned in the budget.

In the process of budget implementation, the municipal council has the right to make amendments to the local government budget, to reduce or increase the amount of financing allocated for the fulfilment of certain functions, and to allocate new financing.

Local governments submit their budget accounts and reports, including special budgets, revenue, expenditure, borrowing and liabilities. These accounts and reports should be submitted in accordance with the procedure set by the Cabinet of Ministers and the Ministry of Finance.

Due to the large number of municipalities it is difficult to forecast revenues and control expenditures on centralised basis. It is impossible to individually rate and estimate the economic development trends of each municipality. Therefore the standard methods of budget planning are used for all municipalities.

In year 1998 several function of regional governments were transferred to rural authorities and towns That explains the decrease in revenues and expenditures of regional governments and increase of revenue for rural authorities and towns in year 1998. The Administrative Territorial Reform was started in 1998 that also increased the municipal revenues and expenditures. Besides the municipal revenues and expenditures are increasing due to inflation, respectively in year 1997- 7.0%, in year 1998- 2.8%, and in year 1999 – 3.2% Cf. Table 3.1 and 3.6).

Publications on local government finance and information exchange

The information exchange between central and local governments on local government finance has been gradually strengthened since 1994. In 1996 the first publication on key figures on local government finance was developed and forwarded to all local authorities. In 1997 an extended version was issued.

The specific budget co-operation

The local government total minimum financial requirement for the economic year is defined in the preparation process of the annual state budget law, and entered in the protocol of annual negotiations between the Cabinet of Ministers and the local government non-governmental organisation which is defined in Article 96 of the Law on Local Governments. The following elements should be included:

1. the total local government financial requirement foreseen for the budget year under preparation;
2. the forecasts for the state macroeconomic figures of the economic year;
3. re-division of functions between local governments, as well as between local governments and the Government, for the economic year;
4. priorities defined for the economic year.

“The Law on the Equalisation of Local Government Finances”, Article 8 Regulation No. 460 “Procedure according to which the Cabinet of Ministers agrees with municipalities on issues concerning the interests of municipalities”, establishes the procedure according to which the Cabinet of Ministers agrees with municipalities on the following issues:

1. the amount of subsidies and target subsidies to be allocated to self-governments in a normal economic year;
2. the procedure for equalising the financial resources of self-governments, if this is not already established by the law;
3. maximum salaries for self-government officials;
4. financial sources necessary for executing the functions established by Article 8 of the law “On self-governments”;

5. how the Cabinet of Ministers should co-ordinate with self-governments on the draft laws and draft regulations of the Cabinet of Ministers dealing with issues concerning self-government activities;
6. other issues concerning self-government activities.

Every year, by 1 July, discussions are held between the Union of Latvian Self-governments and ministries and minutes are taken.

The results of these discussions are recorded and include the issues co-ordinated and any disagreements. The draft record, before signing, shall be sent by the corresponding ministry to the Finance Ministry, the Ministry of Justice and the Ministry responsible. Within two weeks, the Ministry of Justice and the corresponding ministry submit their conclusions on the extent to which the achieved agreement corresponds with normative acts, the possibilities of the State budget to finance the achieved agreement, as well as its impact on the activities of self-governments.

After receiving and evaluating the conclusions, the branch minister or his/her authorised official signs the record or, if necessary, obtains an additional agreement from the Union of Latvian Self-governments, according to the conclusions received. The Chairman, or his/her authorised official, representing the Union of Latvian Self-governments, shall sign the record.

Every year, by 1 August, ministries submit the signed records to the Ministry responsible for registering them and monitoring the implementation of the signed agreements. Should implementation differ from the one stipulated in the agreement, the Ministry responsible, if necessary, informs the Cabinet of Ministers. Copies of records shall be submitted to the Finance Ministry. The Finance Ministry shall submit its agreement record, together with the Union of Latvian Self-Governments, to the Ministry responsible, by 1 September.

The Finance Ministry and the Union of Latvian Self-Governments prepare the discussion agreement record, taking into consideration the agreement on finances, concluded by other ministries. After being signed, the record shall be submitted to the Cabinet of Ministers together with the draft state budget, and its further consideration and submittal to the Saeima takes place in accordance with Article 13 of the law "On the budgets of self-governments", and a copy of the record is sent to other ministries for information.

The financial framework for the coming year is negotiated between the central and local governments during the yearly negotiations. Often, these negotiations result in areas of agreement and areas of disagreement. The disagreements may regard financial needs (the total for all local governments) for the coming year. When the total financial resources for the coming year (including figures for tax revenues and state grants) have been decided by Parliament, the state grants and equalisation figures for all local authorities are decided. The budgets of the local governments are decided by the local authorities (independently) based on the conditions for the total financing for each area.

The basic budget and the special budget

Local governments submit monthly and annual accounts to the State Treasury on the implementation of the basic budget and the special budget.

The local government budget, or the basic budget, covers both the revenue and the expenditure aspects. The Minister of Finance determines the classification of revenue and expenditure. The budget revenue comes from state-imposed taxes, which are included, in full, in local government budgets. They include percentages of state taxes and duties (the share which is not transferred to the state budget), local duties, state budget grants and earmarked grants, payments from the local government financial equalisation fund, service fees, percentages of the profit of local government enterprises, revenue from leasing (renting) out

municipal property, sales of property and other revenue as provided for by the Law “On Local Government Budgets”.

In addition to the basic budget, a special budget may sometimes be drafted to include resources required by local governments to achieve their aims, when:

- the law provides for the covering of expenses from sources of financing earmarked for special purposes;
- the local government or a particular public service institution (implementor) has received a grant or a donation to be used for a special purpose;
- a public service institution (implementor) provides fee services and the income from such services is large enough to be included in a special budget account.

Monthly accounts

Each municipal council submit reports to the State Treasury’s regional offices on a monthly basis, concerning the implementation of the basic budget and the special budget for the period starting at the beginning of the budget year and ending with the month for which the account is made (revenue, expenditure, net loans, surplus/deficit of revenue, financing).

Before the 10th day of each month, State Treasury’s regional offices submit generalised surveys to the State Treasury.

Annual reports

Each municipal council submit reports to the State Treasury’s regional offices on the implementation of the annual basic budget and special budget (revenue, expenditure, net loans, surplus/deficit of revenue, financing), a report on borrowings and loans made, and a balance sheet.

State Treasury’s regional offices submit it to the State Treasury: summary accounts made on the basis of the accounts of rural and urban municipal councils, showing the implementation of the basic and the special budgets (revenue, expenditure, net loans, surplus/deficit of revenue, financing); a report on borrowing and loans, mutual reimbursements among local governments, and state budget grants received by local governments; and a balance sheet.

Local governments’ annual reports have to be audited by the state sworn auditors before submitting to the State Treasury.

Central mandates on economic management

The law “On Budgetary and Financial Management” (Article 6) sets out the budgetary principles for local governments:

1. For each budget year, the local government budget includes all revenue collected or received by the local government (local government institution) and appropriated by the local government for the purpose of achieving its goal.
2. Local government budget resources may only be allocated or received by local governments in accordance with the legally established procedure of appropriation.

3. The distribution of revenue between the state budget and local government budgets, the state budget grant to be allocated to local governments, and the equalisation of economic opportunities among various territories, are all processes set up by laws which regulate revenue, or by special laws, or the current annual State Budget Law.
4. A special law regulates the budgetary rights of local governments.

The Law “On Budgetary and Financial Management” (Article 43) determines the accountancy principles of local government finances:

1. The Minister of Finance determines a uniform classification of local government budget revenue, expenditure, financing and debts, and also sets rules for drawing up budget accounts.
2. All the financial activities carried out by local governments are recorded in the official local government financial register in compliance with the instructions issued by the State Treasury.
3. The reports and accounts are to be drawn up and submitted in compliance with the procedure set out by law and the instructions and orders issued by the State Treasury.

The State Audit Office may check the budget accounts for the current budget year submitted by republican cities, regional, or rural authorities and towns’ municipalities councils, concerning the implementation of their basic and the special budgets.